

TAX·FEATURES

Sen. Pete Domenici to Receive 1986 Distinguished Service Award

US. Senator Pete V. Domenici, Chairman of the Senate Budget Committee, will receive the Tax Foundation's Distinguished Public Service Award for 1986. Hans W. Wanders, President of the Wachovia Corporation and Chairman of the Foundation's Board of Trustees, announced the decision, and will confer the honor upon the New Mexico Republican at the Foundation's 49th Annual Dinner in New York December 3.



Sen. Pete V. Domenici

"Since 1981, Senator Domenici has handled with grace and skill one of the most difficult leadership positions in the United States Congress as chairman of the Senate Budget Committee," Wanders said in announcing the Board's decision. "Throughout his fourteen-year career in the Senate, Mr. Domenici has been in the front ranks of those urging the nation to turn from unrestrained spending toward responsible use of the resources made available to the Federal government by the taxpayers."

Domenici won election to the U.S. Senate in 1972, after practicing law and heading the municipal government of his hometown, Albuquerque, New Mexico. He was the first Republican elected to the Senate from that state in 39 years. In 1984, he was elected to his third consecutive term, with 72 percent of the popular vote, the largest electoral majority in the state's history.

In addition to chairing the Budget Committee, Domenici serves on the Senate Appropriations, Environment and Public Works, and Energy and Natural Resources Committees. He chairs the energy panel's Research and Development Subcommittee.

In 1983, Domenici served as senior counselor on the President's Bipartisan Commission on Central America, and has played pivotal roles in legislation on such critical issues as equal access to justice, natural gas policy, clean air and clean water legislation, research and development of alternative energy sources, maintenance of wilderness areas, agriculture and waterway user fees.

Domenici graduated from the University of New Mexico and earned his law degree at the University of Denver.

New Federal Tax Bill Boon to Most States But Bane to Others

While uncertainties abound as to the short- and long-term effects of the Federal tax bill as it moves toward final passage, one effect is highly predictable: the majority of states will place income tax revision at the top of their legislative tax agenda in 1987. The issues will focus on whether (or how) to adjust state tax laws to avoid revenue distortions that could result from existing linkages in state laws to the Federal Internal Revenue Code.

Potentially, at least 37 states and the District of Columbia would gain revenues because of the Federal tax reform if they did not drop their conformity to Federal law or take other actions.

The "Tax Reform Act of 1986" reduces Federal personal income taxes by around \$122 billion over the next five years, while raising corporate income taxes by a similar amount. In both cases, the changes will come from extensive base-broadening coupled with lower

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Estimated Changes in State Personal Income Tax Receipts in 1988 Resulting from Federal Tax Revision*

STATES WITH POTENTIAL INCREASES OF AROUND 10% (14):

Arizona, *Colorado*, Hawaii, Iowa, Kentucky, *Louisiana*, Maine, Minnesota, *Missouri*, *Montana*, *New Mexico*, *New York*, *Oklahoma*, *Utah*

STATES WITH POTENTIAL INCREASES OF 8 OR 9% (7):

California, *Delaware*, District of Columbia, *Kansas*, *Maryland*, *Virginia*, West Virginia

STATES WITH POTENTIAL INCREASES OF 6 OR 7% (5):

Georgia, Indiana, *Michigan*, *Ohio*, Wisconsin

STATES WITH POTENTIAL INCREASES OF 5% OR LESS (11):

Alabama, Arkansas, Idaho, *Illinois*, Massachusetts, Mississippi, New Jersey, North Carolina, Oregon, Pennsylvania, South Carolina

STATES WITH POTENTIAL DECREASES OF ABOUT 10% (4):

Nebraska, *North Dakota*, *Rhode Island*, *Vermont*

OTHER:

Although *Connecticut* has no broad-based personal income tax, its revenue from capital gains taxation would more than double.

*Estimates assume that states coupled to portions of the Federal tax code as of recent dates will conform to changes in new Federal law. States automatically coupled to provisions of "current" Federal law are shown in italics.

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statutory rates. While changes in both corporate and personal income taxes will be of concern in most states, this article is limited to a discussion of the potential effects of the Federal changes on state personal income tax revenues.

Forty states and the District of Columbia levy broad-based personal income taxes. In 1985 these taxes yielded more than \$64 billion. The states vary widely in the extent to which they rely on these taxes. As a portion of state tax collections, personal income levies range from 6 percent in New Mexico to 66 percent in Oregon.

Nearly all of these 41 jurisdictions have some linkage to the Federal tax law, whether explicit or implicit. (See table on page 3 of *Federal Tax Policy Memo*.) As a starting point for computation of state income taxes, 25 states use Federal Adjusted Gross Income (AGI), six states use Federal taxable income, and four are coupled directly to Federal tax liability. Even the six states with little or no formal linkage to Federal law have some ties in that they will be affected by such items as changes in tax shelters, accounting rules, etc., in Federal law.

The Federal Changes

The accompanying table (see below) lists the changes in Federal tax revenues that will result from the new law, as estimated by the Joint Committee on Taxation. By fiscal year 1988, when most of the provisions will be fully effective, the 18 base-broadening provisions shown at the top of the table below would raise Federal personal income taxes by more than \$67 billion, or 16 percent, in the absence of any other changes in the law. The largest sources of increase are the repeal of the 60 percent capital gains exclusion, repeal of the second-earner deduction for married couples, repeal of Individual Retirement Accounts for most taxpayers, repeal of the sales tax deduction, restriction of tax shelters through at-risk rules and limitations on passive losses, limitation on deductions for nonbusiness interest, restrictions on employee business expenses and miscellaneous itemized deductions, and revisions in the alternative minimum tax.

The four major provisions reducing taxes would lower Federal revenues by around \$11 billion in 1988, or about 26

percent, absent any other changes. These are rate reductions, increases in personal exemptions, increases in standard deductions, and increases in the earned income credit.

Taken together, these pluses and minuses represent a net loss of \$41 billion in Federal revenues for fiscal 1988, or just under 10 percent. Over the five years from 1987-1991, this loss would even out to around 6 percent, according to congressional estimates.

Effect on the States

For 19 states, there will be immediate gains or losses in state personal income tax revenues with passage of the Federal law, unless the

states quickly change their laws. These are the states that couple their taxes to certain provisions of "current" Federal law. (The table on page 1 shows a range of estimated changes in state tax revenue as a result of the Federal changes. The states in italics are those linked to current Federal law.) Depending upon a given state's conformity to Federal law, changes would range from losses of around 10 percent in 1988 to gains of around 10 percent in some states.

The four states that levy their taxes as a percentage of Federal tax liability—Nebraska, North Dakota, Rhode Island, and Vermont—would experience losses of around 10 percent in 1988, although this would be reduced to around 6 percent for the five-year period 1987-1991. (The Vermont legislature, however, has already voted to adjust the state tax rate so as to avoid a revenue loss as a result of the Federal changes.)

In the 15 other states linked to current Federal law, there would be increases ranging from less than 5 percent in Illinois, which has only limited ties to Federal AGI, to 10 percent or slightly more in Louisiana, Missouri, Utah, Montana, New Mexico, New York, Oklahoma, and Colorado. The other states linked to current Federal law would experience increases ranging from 6 to 9 percent. These changes would automatically take place absent changes in state laws.

(It should be noted that the possible changes in state revenues assume that the composition of income in each state is equal to the average for all states. Actual amounts of change for states with relatively higher or lower shares of income from such items as capital gains and tax shelters would vary accordingly.)

(Continued on page 4)

Estimated Revenue Effects of Individual Income Tax Provisions of H.R. 3838, Fiscal Year 1988

Provision	Change in Federal revenue (In millions)
Major provisions increasing taxes:	
Repeal second earner deduction	\$6,016
Repeal income averaging	1,814
Tax excluded part of unemployment compensation	764
Repeal sales tax deduction	4,876
Increase medical deduction floor	1,223
Limit deductions for meals, travel and entertainment	937
Allow employee business expense generally only as itemized deduction; 2% floor on miscellaneous itemized deductions	4,447
Revise treatment of moving expenses	183
Revise capital cost provisions (including repeal of investment tax credit)	2,994
Repeal 60% capital gains exclusion	20,000 ^a
Restrict tax shelters (at risk rules and limitation on passive losses)	4,680
Repeal partial dividend exclusion	573
Revise taxation of regulated investment companies	866
Revise alternative minimum tax	3,904
Tighten certain accounting provisions	1,180
Repeal Individual Retirement Accounts for most taxpayers	4,962
Tighten other pension provisions	3,343
Limit deduction for nonbusiness interest	4,511
Subtotal, increases	67,274
Major provisions reducing taxes:	
Rate reductions	-76,812 ^a
Increase personal exemptions	-26,298
Increase standard deduction	-6,183
Increase the earned income credit	-2,040
Subtotal, reductions	-111,333
Other provisions, net	3,011
Net change in individual income tax liability	-41,048

^aEstimated by Tax Foundation.

Source: Conference Report on H.R. 3838, Tax Reform Act of 1986.

Tax Features

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

SEPTEMBER/OCTOBER 1986

Tax Reform Fallout

In the months ahead, the country is going to be awash with tax advice. Every publisher will be out with their explanation of the big tax reform bill. Seminars on how to cope with it will run endlessly. The lawyers and accountants, who at one point were a little worried about what the flat tax movement would do to their practices, are licking their chops. The parting refrain of the House-Senate conference as they wrapped up the measure in mid-August: We never promised you simplification!

In the days to come, some people will be trying to define just what it all means for the economy and future business prospects. In this task, they will be handicapped severely by the very size and complexity of the reform bill and inadequate tools to measure its effects—the same problems that afflicted the Administration and Congress throughout the long tax reform campaign. Indeed, despite reams of studies, analyses, op-ed pieces, and other materials spawned by the great debate of the past two years, we really have very little to go on as to the overall consequences of H.R. 3838, particularly the long-term consequences, nor are we likely to learn much right after enactment. Final revenue estimates on a static basis for umpteen new provisions will not shed much light. With passage of time, we may gain more insight if tax policy can remain on a fairly even keel. But that is probably much too optimistic an assumption.

Here are some garden-variety observations about the short and intermediate term.

I. Increased Business Tax Burdens. The transfer of \$120 billion or so in tax burdens from individuals to business will not be painless for the economy, for individuals, or politicians. Corporate sector bashing may have played well as pre-1986 election sounds but could become increasingly discordant thereafter.

Repeal of the investment tax credit with relatively harsh transition rules clearly has had a negative impact on business capital spending already. True, the depreciation provisions of the final bill, retaining the heart of the Accelerated Cost Recovery System (ACRS), are considerably more liberal than those of the House version. But even when coupled with lower corporate rates starting in 1987, this will not nearly offset the loss of the investment credit in terms of maintaining productive investment over the current business cycle anyway.

Over five years, the ITC repeal is estimated to account for more than half of the gross revenue pickup from broadening the base of the corporate income tax. But if capital spending continues to sag below projections, a good part of this will not be realized. Other major changes in the corporate sector, including the blockbuster alternative minimum tax and new accounting and capitalization requirements, likely will have adverse effects on investment, too. And, particularly in the

case of the minimum tax, the revenue estimators' basic assumption of all taxpayer behavior remaining the same is very suspect. As a large part of the future base of the minimum tax has not even really been defined yet, it's hard to assess its economic effects. But certainly, there will be many adjustments in business organization and strategy to minimize such a punitive levy.

Currently, the impact of sluggish capital spending has been concentrated in, but by no means confined to, the rustbowl, energy, and cyclical industries. High-tech and others are beginning to feel the pinch, too. In calendar 1987, before the full effect of the reduced tax rates are felt, we are at risk of further slowdown in business activity and erosion of employment. The politics of this situation may be quite different than those from the recent past calling for large increases in corporate effective tax rates.

As an indication of how far things have strayed from the Economic Recovery Tax Act of 1981 (ERTA), we reproduce a table below from the fiscal 1987 budget request showing the effect of major legislation on corporate income tax receipts for the 1985-1989 period and then add the estimated effects of H.R. 3838 through 1989. The business tax cut in 1981, which critics claimed had "destroyed" the corporate income tax, was just about washed out by TEFRA and DEFRA. Reform, obviously, will not only eliminate the small remaining business tax cut from the 1981-1984 legislation but pile on significant net increases, particularly after fiscal 1989 not shown on the table.

**Effect of Major Enacted Legislation, 1981-1986
on Corporate Income Tax Receipts
Fiscal Years, 1985-1989 (\$ bils.)**

	1985	1986	1987	1988	1989
Economic Recovery Tax Act of 1981	-32.0	-43.4	-51.6	-54.9	-56.2
Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)	19.2	30.3	39.7	42.8	42.6
Highway Revenue Act of 1982	-0.2	-0.2	-0.2	-0.2	-0.2
Deficit Reduction Act of 1984 (DEFRA)	3.3	5.8	8.1	9.7	10.6
Net Effect⁽¹⁾	-12.1	-10.5	-7.4	-5.2	-4.2
Tax Reform Act of 1986		(2)	+25.2	+23.9	+22.5
Total Net Effect	-12.1	-10.5	+17.8	+18.7	+18.3
Addendum					
Net Effect of Period Legislation on Individual Income Taxes	-114.9	-133.5	-170.1	-219.1	-240.8

⁽¹⁾ Individual acts do not sum exactly to net effect because of interaction effects.
⁽²⁾ Impact on Fiscal 1986 not shown in Conference Report on H.R. 3838.

Source: Budget of the U.S. Government, FY 1987, and Conference Report on H.R. 3838, The Tax Reform Act of 1986.

II. Rate Reductions and Individual Sector Changes.

Clearly, the individual marginal rate reductions were the driving force for reform from the beginning. It is interesting to note that the basic rate structure that finally emerged is virtually identical to the original Bradley-Gephardt proposal back in 1982, which marked the start of the modified flat tax movement as a serious legislative concern. The President put his weight squarely behind rate reduction—some say to the exclusion of legitimate concerns about the business tax burden. And, of course, the dramatic rescue of reform in the Senate Finance Committee last Spring was sparked by the combination of sharply lower top rates and moves against tax shelters that appealed to both conservative and liberal members. Still, the 15 and 28 percent basic rates that the conference eventually approved were accommodated only by accepting the Senate phaseout of the benefit of the 15 percent rate and personal exemption and by a surprising backdown by the House accepting complete repeal of the state local sales tax deduction.*

It should be kept in mind, of course, that people pay taxes not tax rates. With all the churning of the tax base, the loss or restriction of itemized deductions, the repeal of income averaging and the second-earner deduction, the increase in effective capital gains taxation, and the attack on tax shelters, significant numbers of taxpayers in income groups above \$20,000 will experience tax increases. A Joint Committee on Taxation analysis of the Senate bill indicated that 26 percent of the \$20,000-\$30,000 AGI group would incur such increases and that percentage would rise irregularly to 44 percent of the over-\$200,000 AGI group. Very similar proportions should pertain to the final bill which, for purposes of this comparison, is very close to the Senate version. Furthermore, although the conference agreement did ameliorate the "stagger" problem in the Senate bill of tax rates being lowered six months after deductions were lost, it didn't solve it. The March 15, 1987, effective date for rate reductions still means more tax increases for some, or lesser tax decreases for others, in calendar 1987.

Overall, the net tax cut for individuals when the rate reductions are fully effective is said to be 6.1 percent. This probably will have some positive impact on future consumer demand. Ironically, there may be more pronounced effects in the remaining months of 1986 if consumers load up on big-ticket items on which sales taxes are still deductible, cash in capital gains at lower effective rates than next year, and make other timing adjustments to limit the loss or restriction of various tax provisions. But any speedup of consumer buying right now because of these factors could detract from the 1987 economy.

III. **Federalism.** Some of the governors have real complaints about the process of Federal tax reform. In general, the Feds

appeared to pay little attention to the impact of what they were doing on state local tax structures and economies. Among the states, there was a lot of discontent about the Administration's proposal to eliminate all state local deductions from the Federal base. This subsided when the House left the state local deductions alone but was revived, to a lesser extent, by the Senate Finance Committee proposal to eliminate general sales tax deductibility.

Denying a Federal deduction for one important source of state local revenue while keeping it for income and property taxes, would seem to clash with our traditional concept of Federalism. It's unlikely to cause states to abandon sales taxes but certainly could affect future choices as to the balance of their fiscal sources. As of 1984, 14 states depended on general sales taxes for 40 percent or more of their overall state tax collections, and 44 states collected 20 percent or more of their total from general sales taxes. Only five had no general sales tax. So it is a significant issue for the governors and state legislatures, who, quite properly, resent the Federal interference.

Their ire may be soothed, however, by the bonanza that most states will get from broadening the Federal income tax base (see *Tax Features* story on page 1 and table on page 3 of this article). The gross broadening of the individual and corporate income tax base is estimated to pick up more than \$500 billion in Federal revenues over five years and expand the Federal tax base by a multiple of that figure. Almost all of the 41 states with personal income taxes and 46 states with corporate income taxes will get part of this pie. Some would get more than others, depending on the extent to which their own tax bases and personal exemptions are tied to Federal levels. All of the states with income taxes based directly, or indirectly, on the Federal structure will be under pressure to reduce their own rates to pass on the savings to their own taxpayers. But this will not be a uniform process; some will want to use the opportunity to expand state local expenditure programs.

Also, it should be noted that the "bonanza" is not really automatic. Even among states that copy the Federal base the closest, most do so as of a specific date for the Federal Code. Assuming these want to go along with the Federal changes, they will have to update their relationship and, presumably at the same time, reduce their own rates and/or take other actions.

IV. **Revenue Neutrality and the Budget Deficit.** It's hard to believe that H.R. 3838 really will be revenue neutral over five years. Significant change in taxpayer behavior in response to the massive measure can be expected, and generally this will act to undercut static revenue estimates. The revenue estimators, for example, are counting on a very large increase in capital gains tax receipts in 1987-1991. But with the jump in effective capital gains rates, particularly under the maximum, realizations could be well below trend, just as they were above trend following the capital gains tax reductions in 1978.

For the short term through fiscal 1987, the reform bill probably still will produce some net revenue gain because of the remaining "stagger," and this offers a partial escape from

*In the "old" days, such a conference provision almost certainly would have been challenged as going beyond the limits of the House and Senate bills. In the case of H.R. 3838, the House version left the sales tax deduction intact while the Senate version preserved 60 percent of it. In these days, however, conference compromises seem to go wherever the conference wants to reach agreement, not the lines drawn by the full House and Senate.

the budget dilemma, a way to help close the budget deficit—on paper anyway—without going through the rigors of a Gramm-Rudman-Hollings sequester. Whether or not the Congressional leadership will accept this "help" for budget reconciliation purposes is uncertain.

No such luck in fiscal 1988, when the budget deficit target is reduced to a little over \$100 billion and the reform bill is estimated to lose revenue. Chairman Rostenkowski recently repeated his view that, with a fairer tax base from reform, the budget deficit should be addressed by raising tax rates. We would still bet against this, at least through fiscal 1988 and probably beyond. There is just too much political capital tied up in the lower rates to envision an intermediate-term rate increase. Tax action to help close the deficit, if any, will have to come from another source or sources.

Tax Burden Distribution and Fairness

One thing that Congress never specifically voted on, but which became an important rule of the road for tax reform, was maintaining the existing distribution of individual tax burdens. It probably was necessary to move reform through the political process and avoid class warfare. It was felt that individual tax burdens as between broad income classes should remain the same, except for the very bottom, where those below the poverty level would be removed from the rolls entirely. The emphasis would be on more "horizontal" equity within income classes, particularly at the upper end.

But unfortunately, there was a downside to this, too. Measurement of tax burdens by income class is somewhat more precise than estimating overall economic effects of tax change, but not much. For numerous special provisions, the Joint Committee on Taxation, although required to provide a revenue figure, is unable to come up with any distribution by income class. Nevertheless, in the tax reform consideration, there was rapt attention paid to very minor projected changes in tax burdens as if they signified major social impact. The whole question of whether the middle-income class should get an estimated 7 percent tax cut, as in the Senate bill, or 9 percent, as in the original House bill, was way overblown.

Decisions were made on some important provisions more on the basis of how many percentage points—or tenths of percentage point—change would occur in the distribu-

Relation of State Personal Income Tax Laws to Federal Internal Revenue Code^a

As of September 1986

State and nature of link to Internal Revenue Code	Date of linking	Additional linkages to or deviations from Federal base ^b
States linked to Federal AGI (25):		
Arizona	1/1/86	No 2-earner deduction; Federal itemized deductions but no medical expense floor; Federal tax deductible
Colorado	Current	No 2-earner deduction; Federal itemized deductions; Federal tax deductible
Delaware	Current	Federal itemized deductions; limited Federal tax deduction
Dist. of Columbia	5/24/85	Federal itemized deductions; no 2-earner deduction
Georgia	1/1/81	Limited IRAs; no 2-earner deduction; Federal itemized deductions as of 1/1/81
California	1/1/86	\$1,500 limit on IRAs; no 2-earner deduction or dividend exclusion; does not tax unemployment compensation; Federal itemized deductions
Illinois	Current	Taxes 100% of capital gains; no dividends received exclusion; no 2-earner deduction; no itemized deductions
Indiana	1/1/86	No 2-earner deduction; no itemized deductions
Iowa	1/1/86	No 2-earner deduction; Federal itemized deductions; Federal tax deductible
Kansas	Current	Federal itemized deductions as of 12/31/77; Federal tax deductible
Kentucky	12/31/85	Federal itemized deductions; limited federal tax deduction
Louisiana	Current	Federal itemized deductions; Federal tax deductible
Maine	12/31/85	Federal itemized deductions
Maryland	Current	No 2-earner deduction; no dividends received exclusion; Federal itemized deductions
Massachusetts	1/1/85	Taxes 50% of capital gains; no IRAs; no 2-earner deduction; no itemized deductions
Michigan	Current	No 2-earner deduction; no itemized deductions
Minnesota	12/31/85	Does not tax unemployment compensation; generally allows Federal itemized deductions; Federal tax deductible under optional rate schedule
Missouri	Current	Federal tax deductible; provides optional Federal standard deduction; Federal itemized deductions
Montana	Current	Does not tax unemployment compensation; Federal itemized deductions; Federal tax deductible
New Mexico	Current	Generally allows Federal itemized deductions
New York	Current	Federal itemized deductions
Ohio	Current	No itemized deductions
Virginia	Current	No 2-earner deduction; Federal itemized deductions
West Virginia	1/1/86	No 2-earner deduction; Federal itemized deductions
Wisconsin	12/31/85	No 2-earner deduction; no Federal itemized deductions
States linked to Federal taxable income (6):		
Hawaii	12/31/85	No 2-earner deduction; Federal itemized deductions but not Federal exemptions and standard deduction
Idaho	1/1/86	Federal exemptions and deductions
Oklahoma	Current	Does not use Federal exemptions and standard deductions; optional Federal tax deduction
Oregon	12/31/84	Federal exemptions and deductions; Federal tax deductible
South Carolina	12/31/85	Federal exemptions and deductions
Utah	Current	Federal exemptions and itemized deductions; standard deduction as of 12/74; current Federal itemized deductions; Federal tax deductible
States linked to Federal tax liability (4):		
Nebraska	Current	
North Dakota	Current	Option to pay tax based on Federal taxable income
Rhode Island	Current	
Vermont	Current	1986 legislature voted to adjust tax rate to avoid loss from Federal tax changes

(Table continued on page 4)

**Relation of State Personal Income Tax Laws to Federal
Internal Revenue Code^a (continued)**
As of September 1986

State and nature of link to Internal Revenue Code	Date of linking	Additional linkages to or deviations from Federal base ^b
States with little or no linkage to Internal Revenue Code (6) ^d :		
Alabama	1-1-82	Allows IRAs; generally conforms to Federal itemized deductions; Federal tax deductible
Arkansas	1-1-83	Allows IRAs
Mississippi		Allows IRAs; Federal itemized deductions
New Jersey		
North Carolina		Allows IRAs; 5% floor on medical expense deduction
Pennsylvania		
States without broad-based income taxes (3):		
Connecticut		Taxes 40% of capital gains; dividends and interest
New Hampshire		Taxes dividends and interest
Tennessee		Taxes dividends and interest
States without an income tax (7):		
Alaska		
Florida		
Nevada		
South Dakota		
Texas		
Washington		
Wyoming		

^aCovers features relevant to Federal tax changes in 1986.

^bStates shown as allowing "Federal itemized deductions" do not allow deduction of state income tax in computing state tax.

^cIn addition to these six states, North Dakota allows taxpayers to choose between computing tax based on Federal taxable income or a percentage of Federal tax liability.

^dAll of these states tax 100% of capital gains as ordinary income.

Source: Tax Foundation compilation based on Commerce Clearing House, *State Tax Guide*.

tion table than the policy logic itself. Heavy reliance on the distribution tables was particularly evident in the decisions to tax capital gains as ordinary income, and thus justify the lower rates as applied to upper-income groups, and also in the restrictions on passive loss deductions. The effects of these reforms on investment incentives were relegated to the background.

In the end, Congress produced a huge mass of changes that, on paper anyway, showed very little difference in the overall proportions of taxes paid by income groups, except, of course, for the very bottom. In the torturous pursuit of the "correct" distribution, some important policy considerations may have been overlooked or ignored.

Despite the jerry-built reform process and disturbing ten-

dency of the tax-writers to make a number of their decisions retroactive, the individual income tax structure, on balance, could be viewed as "fairer" in the future if taxpayers believe that others in the same general economic circumstances are paying taxes in the same ballpark. The perception of horizontal equity is very important. If reform succeeds in improving this, it will go a long way to renew some respect for the system and restore compliance.

Efficiency and Growth

Right after announcement of the 1984 Treasury reform proposal, there was a spate of econometric studies, mostly concluding that such reform would cut capital spending and dampen economic growth. These were criticized for not taking into account the long-term productivity improvement that would accrue from lower rates and better measurement of economic income, etc. But neither the Treasury nor anyone else ever produced any convincing, in-depth analysis of prospective efficiency gains. Then much of the proposed improvement in income measurement, such as through indexing and relief of the double taxation of dividends, went a'glimmering in Congress. We are left really with a good faith decision that the lower rates and somewhat more even distribution of tax burdens will produce a more efficient system. Which they may do. There is no denying that if we can maintain a top corporate tax rate of 34 percent and a top individual rate of 28

percent (or even 33 percent temporarily) this will help make the United States an attractive marketplace in the global context. Note the key words, "*if we can maintain*." This may be the biggest uncertainty of all.

In the coming months, this column will be looking closely at sectors most affected by tax reform, including capital recovery, employee benefits, and foreign source income. Whatever the macro effects of reform, there are many significant sectoral issues that will need to be analyzed carefully for the inevitable next round of tax legislation. As Majority Leader Bob Dole put it, "There will be a technical corrections bill, and maybe some things that are not so technical will be dealt with at that time."

Federal Red Ink Cuts Savings Rate By Nearly 1/3

Fiscal profligacy by government—notably by Uncle Sam—is reducing the gross savings rate in the United States by nearly one-third, Tax Foundation analysis reveals.

In the second quarter of 1986, gross private savings of individuals and businesses totaled \$718.7 billion, or 17.2 percent of GNP. State-local transactions added another \$59.9 billion to the savings total (1.4 percent of GNP), bringing total savings—excluding Federal transactions—to \$778.6 billion, 18.6 percent of GNP.

Federal red ink cut that savings rate by more than 30 percent, reducing actual gross savings to 13.0 percent of GNP, economists at the Washington-based fiscal watchdog organization say.

Combined deficits of all government units in the United States were running at an annual rate of \$177.0 billion, seasonally adjusted, in the second quarter of 1986—the largest combined deficit on record. It topped the first quarter deficit of \$131.6 billion—by \$45.4 billion.

These findings by Tax Foundation economists are based on data recently released by the Bureau of Economic Analysis, as reflected in the national income and product accounts (NIPA). The data vary in several respects from the way governments keep their books. For example, the NIPA data exclude capital transactions that do not represent current flows of income and production—these are purely financial transactions or transactions in existing physical assets.

Overall, government deficits occurred in fourteen of the last sixteen years, 1970 through 1985. In every year during that time, the Federal government operated at a deficit, by amounts ranging from \$5.6 billion in 1973 to over \$200 billion today. The highest deficit prior to the 1980's was recorded in 1975 at \$69.4 billion.

In sharp contrast to the performance of the Federal sector, state and local units combined experienced surpluses every year since 1969, by amounts ranging from \$1.8 billion in calendar year 1970 to \$70.0 billion in the first quarter of 1986.

(The Bureau of Economic Analysis includes transactions involving state

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THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation

"Beware of the Sooths!"

The ancient Romans used sheep entrails. The plains Indians cast chicken bones. Washington policy-makers scan statistical projections. Which system is more reliable is anybody's guess.

As Alfred L. Malabre, Jr., writing in *The Wall Street Journal* last May 12 put it: "Trying to forecast the economy's ups and downs may not be quite as unscientific an enterprise as fortune-telling. But it assuredly lacks the precision enjoyed by, among others, the TV weather people."

Perhaps the mistake originated in the economists' desire to gain stature by claiming a predictive ability for the specialty that it did not possess. Perhaps the fault belongs to the politicians who cynically practice "rent-a-consultant" in order to produce forecasts that fit their policy options. Maybe it was all of us, frail, frightened humanity, simply translating into twentieth century terms our age-old desire to pierce the veil of the future and carry home the trophy of certainty.

Regardless. Let's repent, and admit that, if anyone could predict the next ten minutes with absolute certainty, he'd be at the racetrack growing rich.

Now all of this would be good clean fun, if the opinings of economists merited only the level of attention accorded the predictions aired on "Entertain-

ment Tonight." The tragedy lies in using such tenuous "scientific" extrapolations to underpin public policy.

Rosy Scenario as applied to the Federal budget is only the most flagrant example of abuse of the economic forecasts. The widely followed and highly regarded Index of Leading Indicators published monthly by the Commerce Department may have a more honorable pedigree than Rosy. But it seems to have little more predictive validity.

For one thing, the Index is still heavily weighted toward domestic manufacturing although we have shifted to an economy that is increasingly dominated by service and export industries. For another, events quite simply do not bear out the Index's predictions. The Leading Index predicted recessions in 1950, 1962 and 1966 that never materialized. Even when the Index correctly predicted a downturn, the peak occurred anywhere from three to 21 months before sliding over the edge into recession. That's not even close enough for government work!

Decision-makers would be just as safe flipping a coin as consulting some of our economic forecasts. In fact, one could picture a day when, by slavishly following "scientific" forecasts that fail to work out, they will be left with no coins to toss.

THE BIG QUESTION



(FEDERAL TAX BILL, from page 2)

The remaining 22 jurisdictions have the option of updating their laws in response to the new Federal code. Many of them customarily couple to the latest definitions of the Internal Revenue Code and presumably would do so in years to come. The table on page 2 estimates potential increases these states would receive—their taxpayers would pay—if the states do adopt the Federal changes in provisions to which they are now tied.

State elected officials are free to determine their own tax policy, without regard to Federal rules. On the whole, it seems questionable whether many of them will find it politically feasible to pass on to their taxpayers higher state bills simply as a result of changes in Federal law.

Officials in a few states have indicated that they will need to keep the "windfall" increases because of serious budgetary problems. In most states, however, it is expected that adjustments will be made to avoid changes in state revenues.

States have a number of options. Some may choose to increase their exemptions and/or lower statutory rates to leave personal income tax revenues unchanged. Some may choose to keep the income tax "windfall" and lower other taxes, especially general sales taxes which will no longer be deductible in computing Federal taxes.

Still other states may wish to take a wait-and-see stance. The estimated revenue effects of the Federal changes even on national revenues are at best approximations, based on economic and other assumptions that may not prove accurate.

Whatever the various states decide, it

is clear that state legislatures will have a crowded agenda in 1987.

(GROSS SAVINGS, from page 3)

unemployment insurance in Federal social insurance funds, in keeping with the concept applied in the unified Federal budget.)

Among states and localities in the second quarter, both general funds and social insurance funds operated in the black. Funds other than social insurance showed a slim surplus of \$4.9 billion, the leanest in three years. Social

insurance funds showed a combined surplus of \$55.0 billion.

Much of the apparent affluence of state-local treasuries is due to the continuing excess of receipts over expenditures in social insurance funds, largely employee retirement systems.

In only two years since 1969 have all governments combined had surpluses—1973 and 1979. During these years, state-local operations—primarily social insurance funds—were sufficient to offset negative balances in the Federal accounts.

Sources of Gross Savings in the United States^a Calendar Years 1980-1986

Year	Private saving ^b	Government surplus or deficit			Total gross saving
		Federal	State and local	All governments	
Amount (millions)					
1980	\$478,400	\$-61,334	\$26,800	\$-34,534	\$448,960
1981	575,500	-63,785	34,116	-29,669	520,860
1982	557,100	-145,868	35,115	-110,753	446,300
1983	592,200	-176,030	47,472	-128,558	463,600
1984	674,800	-169,989	68,475	-101,514	571,400
1985	687,800	-198,038	61,708	-136,330	551,300
1986					
QI ^c	714,800	-201,600	70,000	-131,600	581,200
QII ^c	718,700	-236,900	79,900	-157,000	541,700
Percent of gross national product					
1980	17.5	-2.2	1.0	-1.3	16.2
1981	18.0	-2.1	1.1	-1.0	17.1
1982	17.6	-4.6	1.1	-3.5	14.1
1983	17.4	-3.2	1.4	-3.8	14.6
1984	17.9	-4.5	1.8	-2.7	15.2
1985	17.2	-5.0	1.5	-3.4	14.8
1986					
QI ^c	17.2	-4.9	1.7	-3.2	14.1
QII ^c	17.2	-5.7	1.4	-4.2	13.0

^aData as shown in the national income accounts; government figures vary from those shown in the Federal budget and state-local budgets because of conceptual and timing differences. For example, government disbursements exclude amounts associated with purely financial transactions and asset sales.

^bIncludes personal and business saving.

^cSeasonally adjusted annual rates.

Source: Department of Commerce, Bureau of Economic Analysis, and Tax Foundation computations.



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TAX·FEATURES

Federal Debt Ceiling Hits \$2.3 Trillion; \$10,000 Apiece for All U.S. Residents

Shadow Budget Committee Says Continuing Resolutions Threaten Budget Process

Abuse of continuing resolutions is growing and "reflects a real breakdown of orderly budgeting in Congress and undermines the capacity of both the Legislative and Executive Branches to make responsible spending decisions," according to a recently released report from the Tax Foundation's Shadow Committee on the Federal Budget.

The omnibus spending bill passed October 8, the Committee report asserts, contained "an extraordinary provision" that "could threaten the very basis of constitutional government in the United States," if it became a precedent for more expanded use. The provision in question, which was effective through October 8, would have allowed certain regular appropriation bills to become law "without final passage by Congress and without presidential review," the report charged. "The resolution would allow conferees 'to set spending at any level they wanted, and insert any extraneous legislation, and neither the President nor Congress would have any recourse.' Imagine the mischief that might be done if this type of provision were effective for a full fiscal year!

"Continuing resolutions are not new legislative devices; they were first used more than a century ago (in 1876) when Congress provided interim funding for certain accounts that had not received regular appropriations by the start of the fiscal year. But the evolution of continuing resolutions into massive measures that supplant regular appropriations, provide full-year (not just stopgap) financing for many Federal programs and agencies, and serve as a vehicle for unrelated legislation is a recent development. Consequently, these resolutions have grown dramatically from 1-2 pages in the early 1970s to 363 pages in fiscal 1985 and 142 pages in fiscal 1986.

Appropriations committees use the resolutions to veto-proof bills that contain spending levels at variance with the Administration's. Committees and individual Members load preferential riders on the resolutions that would never make it through the legislative pipeline.

Why does the continuing resolution serve these covert agendas so well? First, continuing resolutions are

(Continued on page 2)

What goes up must come down—unless it's the Federal debt. Uncle Sam's indebtedness, like Topsy, just keeps growing.

The latest peak in the Alpine reaches of the alleged Federal debt "ceiling" is \$2,300 trillion. It hove into view last October 18, when Congress ok'd a \$189 billion "temporary" increase before rushing home to face the voters. That action recognizes that every man, woman, and child in the United States will be owing about \$10,000 apiece as their "share" of the national debt in 1987, triple the amount ten years ago.

Only a Temporary Solution

The debt ceiling boost, the 24th in the last 10 years, again is only temporary. Congress must act by next May 15, or the legal ceiling will revert to \$2,111 trillion. Don't bet on that happening. Because of continuing deficits, some time next year, Congress will need to pass another debt ceiling hike, probably well over the \$2.3 trillion mark.

This October's hike in the debt ceiling was the second one this year. In August Congress approved a \$32 billion increase that was needed to pay September 3 Social Security benefits without adversely affecting the Social Security trust funds.

Earlier this year both the House and Senate approved bills that would have raised the ceiling even

(Continued on page 3)

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Federal Deficits, Debt Outstanding, and Related Measures

Selected Fiscal Years 1977 - 1987
(Billions, except per capita)

Year	Debt outstanding ^a		Net interest	Deficit	Outlays	Receipts
	Total	Per capita				
1977	\$709.1	\$3,210	\$29.9	\$-53.6	\$409.2	\$355.6
1978	780.4	3,495	35.4	-59.2	458.7	399.6
1979	833.8	3,693	42.6	-40.2	503.5	463.3
1980	914.3	4,002	52.5	-73.8	590.9	517.1
1981	1,003.9	4,349	68.7	-78.9	678.2	599.3
1982	1,147.0	4,919	85.0	-127.9	745.7	617.8
1983	1,381.9	5,869	89.8	-207.8	808.3	600.6
1984	1,576.7	6,634	111.1	-185.3	851.8	666.5
1985	1,827.5	7,617	129.2	-211.9	946.0	734.1
1986	2,129.5	8,792	135.3	-220.7	989.8	769.1
1987	2,354.9 ^b	9,631 ^b	140.9 ^b	-163.4 ^c	990.5 ^c	827.1 ^c

a. End of fiscal period

b. Office of Management and Budget estimate as of August 6, 1986.

c. Average of estimates by Congressional Budget Office and Office of Management and Budget in Initial Sequestration Report for Fiscal Year 1987, August 20, 1986.

New 1986 State Laws To Boost Taxes In 16 States; Cut Them in 4 States

State legislation in 1986 will boost taxes in 16 states by a total of \$2.4 billion annually and will cut taxes in another six states by \$.8 billion, according to a Tax Foundation survey. The net effect of the statutory changes is to raise the annual level of overall state taxes by \$1.6 billion. That is equivalent to less than one percent of fiscal year 1986 collections, which are estimated at \$227.7 billion, say Tax Foundation researchers.

This was the third straight year in which the net changes enacted were less than one percent of state tax collections.

This year's new state tax laws dealt predominantly with levies on general sales, motor fuels, and personal income. Six states hiked sales tax rates, eight states raised motor fuels rates, five increased cigarette taxes, two increased corporate income taxes, and one state raised personal income tax rates. Six states took action to reduce their personal income taxes.

Altogether, Idaho, Kansas, Nebraska, New Mexico, Virginia, and Texas will pick up an additional \$1.3 billion a year in new revenue from higher sales tax rates. Idaho's rate will rise from 4 percent to 5 percent, for the period April 1, 1986 through June 30, 1987. The Kansas rate goes from 3 percent to 4 percent, beginning July 1, 1986. The Nebraska sales tax rate will rise from 3.5 percent to 4.5 percent on January 1, 1987. New Mexico's rate hike, from 3.75 percent to 4.75 percent, took effect on July 1, 1986. For the period January 1, 1987 through August 31, 1987, the Texas sales tax rate will rise from 4.125 percent to 5.25 percent. Virginia's increase, from 3 percent to 3.5 percent, becomes effective January 1, 1987.

Most of the remaining increase—nearly \$1 billion—will come from motor fuels tax increases in Colorado, Delaware, Kentucky, Montana, North Carolina, Tennessee, Texas, and Virginia. In Colorado the gasoline tax was raised from 12 cents to 18 cents a gallon; Delaware, 11 cents to 13 cents; Kentucky, 10 cents to 15 cents; Montana, 15 cents to 17 cents; North Carolina, 12.25 cents to 14.25 cents; Tennessee, 12 cents to 15 cents; Texas, 10 cents to 15 cents; and Virginia, 11 cents to 17.5 cents.

Cigarette tax increases will add about \$90 million to revenues in Colorado, Florida, New Mexico, Rhode Island,

and Washington. By raising its rate from 23 cents to 31 cents a pack of 20 cigarettes, Washington gained the distinction of having the highest rate in the nation. Other increases were in Colorado, 15 cents to 20 cents a pack; Florida, 21 cents to 24 cents; New Mexico, 12 cents to 15 cents; and Rhode Island, 23.4 cents to 25 cents. In addition, four states—Colorado, Maine, New Mexico, and Washington—levied a new tax on tobacco products that had not been previously taxed.

New Mexico was the only state to raise personal income taxes. Colorado and Maine increased corporate tax rates. In addition to other changes, Maine doubled its excise taxes on beer, wine, and spirits.

Personal income tax cuts in Connecticut, Delaware, Massachusetts, Michigan, Pennsylvania, and Vermont account for nearly all of the 1986 legislative tax reductions. Connecticut lowered its tax on dividends and capital gains, beginning January 1, 1986. Delaware cut its personal income tax rates by 9 percent for tax years after 1986. Massachusetts repealed a 7.5 percent surtax on its tax, retroactive to January 1, 1986. Michigan accelerated a scheduled cut in its income tax to save taxpayers an estimated \$360 million annually, effective April 1, 1986, the flat-rate tax dropped from 5.1 percent to 4.6 percent. Pennsylvania cut its flat-rate tax from 2.2 percent to 2.1 percent, effective September 1, 1986; and Vermont dropped its rate from 26.5 percent of Federal tax liability to 24 percent for tax years beginning after 1986. The Vermont legislature also stipulated that if Federal tax provisions were changed after the legislature adjourned and before the 1987 legislative session began, the state tax rate could be altered to obtain the same revenues as the amount anticipated before the Federal changes.

In addition to lowering its personal income tax rate, Pennsylvania cut its corporate income tax rate, effective in calendar year 1987, from 9.5 percent to 8.5 percent. In other action on corporate income taxes, California, Idaho, New Hampshire, and Utah revised their taxation of multinational corporate income from a worldwide to a water's-edge basis; that is, the states will tax multinational corporations only on their income produced in the United States.

(SHADOW BUDGET COMMITTEE,
from page 1)

not covered by the House's rules barring legislation in appropriation bills. Second, as the "last train out of the station," the continuing resolution is often the final chance to move a stalled bill down the tracks. In addition, the stalled item is virtually hidden within the haystack of the resolution's legal verbiage. As a result, the length of continuing resolutions has mushroomed.

Number of Pages in Lengthiest Continuing Resolution

Fiscal Year	Pages
1980	8
1981	9
1982	21
1983	95
1984	19
1985	363
1986	142

What can be done? The Shadow Budget Committee notes that any reform, if it is to succeed, must "take away the advantages of delay" and must not give undue leverage to any side.

"Automatic continuation of programs and agencies which have not received their regular appropriations by the start of the fiscal year at or before the previous year's spending level would provide Congress with a strong incentive to act on the regular appropriations bills."

Finally, to remove the continuing resolution's attractiveness as a vehicle for unrelated legislation, the Committee recommends that such resolutions "be made subject to House and Senate rules barring legislation in appropriation bills."

The report, "The Misuse of Continuing Resolutions," is available from the Tax Foundation for \$4, plus \$1 postage and handling.

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

Evolution of a New System

NOVEMBER/DECEMBER 1986

By Frederic W. Hickman

Most are aware that the pace of tax "reform," so-called, has picked up in recent years. The table on page 6 is a summary of the major revenue bills over the last 40 years, since the end of World War II. During the first half of that period there were a number of revenue acts, occurring at reasonable intervals. But most of them were what you might call economist's acts, that is, they responded to the need to increase or reduce tax revenues and did not involve much reform. The Revenue Act of 1962, the major revenue act of the Kennedy Administration, did institute major changes designed to encourage investment and lift the economy from a relatively stagnant condition. But it did not tinker extensively with the tax machinery.

The real tax reform movement commenced with the Tax Reform Act of 1969. It was enacted in the first year of the Nixon Administration, but it was, in fact, a legacy left from the prior Johnson Administration in the form of a large package of Treasury reform proposals floated just prior to the end of that Administration and attended by extensive publicity about a relatively few high-income individuals who paid little or no tax.

From 1969 to date the Congressional tax-writing committees have been engaged almost without interruption in the consideration of so-called "tax reform" proposals. Tax-writing committees, which used to meet on a far less than regular basis, have been meeting daily, week in and week out.

The Tax Reform Act of 1981, the first revenue act under the Reagan Administration, provided the largest tax cut in history and substantially liberalized many tax provisions. The next three tax acts, the latest of which is the one before us, have been devoted in significant part to reversing the benefits conferred in the Revenue Act of 1981.

Responsible for Accelerating Tax Changes

If we can identify the factors that were responsible for this unrelenting legislative activity, we will perhaps have a clue as to what we can expect in the future.

• *Inflation and the "fiscal dividend."* The first factor accounting for all this activity has been inflation and the so-called "fiscal dividend" that results from inflation. Under a graduated rate tax system, as money incomes rise, tax revenues rise even faster because a larger percentage of the total income is thrown into progressively higher brackets. This

phenomenon is sometimes referred to as "bracket creep." At the same time, real incomes also rise, compounding the effect. The extra revenues that result are sometimes referred to as the "fiscal dividend." Government spending has also risen throughout the period, but during much of the period

Conclusions on the Tax Reform Act of 1986

1. The tax changes enacted are massive in terms of their number and the complexity and mischief they will create. In terms of dealing with fundamentals, the single big change is a dramatic reduction in marginal rates. All the rest is shifting and tinkering. But the shifting and tinkering is, in total, massive, and may have major fallout.

2. There are no revolutionary ideas or concepts involved. The basic approach, which is to broaden the tax base and lower the rates, has been under discussion for 50 years. If you went to the Treasury Department attic and plowed through its old trunks of tax proposals you would find repeated proposals for most of what has been done in this bill.

3. In terms of the Act's long-run effect on the economy, some believe lower, marginal rates will work miracles. Most don't believe that. Many believe that changes, dislocations or disruptions will be major negative influences. In any event, the economy will survive. The biggest changes are simply undoing, either directly or indirectly, events that occurred in the last decade or so. The economy survived and prospered before those changes occurred, and it will survive and prosper after they are undone. In the grand scheme of things the tax changes are a relatively minor influence.

4. In the short run, the impact on the economy is apt to be sharply negative. That is because the hundreds of small changes will disrupt existing procedures and relationships. Companies will have to revamp a great many existing procedures in order to remain competitive. They will do that successfully in most cases. But there is a cost in the dislocations and revamping, not the least of which is unemployment. Time and resources devoted to dislocation and restructuring are time and resources not used to produce goods and services.

5. A great many of the substantive tax changes in the new legislation are simply wrong—wrong, that is, in the context of accurately measuring income.

6. The final product is full, if you will, of new instabilities. We will almost certainly be rewriting the tax laws next year, the year after, and for as many years as the mind's eye can see.

ABOUT THE AUTHOR

FREDERIC W. HICKMAN is a partner in the Chicago law firm of Hopkins & Sutter, specializing in taxation matters. From 1972-1975, Mr. Hickman served as Assistant Secretary of the Treasury for Tax Policy. He has lectured widely on tax subjects. The following remarks are excerpted from an address to the Tax Foundation's 38th National Conference in December 1986. The opinions expressed are those of the author and do not necessarily reflect those of the Tax Foundation.

revenues increased even faster than spending. Congress could, therefore, indulge in cutting taxes, an activity it finds only slightly less pleasurable than spending. Tax reform involves selected tax increases and is almost always painful politically, but becomes tolerable if it occurs in the context of general tax reductions. So the first and probably most important factor is that progressively increasing revenues kept the Congress in a tax legislating, tax reduction mode.

• **Changing economic theories.** A second factor had to do with changing economic theories. In the 1940's and 1950's Keynesian economists were preoccupied with concepts of excess saving and inadequate spending. In the 1960's their emphasis began to change to the need for economic growth. The first major manifestation of the change was the Kennedy Revenue Act of 1962. This theme has dominated the thinking since, and has produced a series of proposals designed to encourage growth.

• **Rules proliferation and the "breeder reactor" effect.** A third factor has to do with the fact that, at least in the tax area, technical rules proliferate in a self-generating way. Like the breeder reactor in the nuclear field, one change fuels an even greater number of new changes. As the rules network becomes increasingly complex, there are more cracks between rules simply because there are more rules, and that in turn provokes new rules to stop up the cracks, which in turn generate new cracks.

• **PACs.** A fourth factor has to do with the rise of the PAC. Congressmen used to count on handing out benefits in order to influence voters. As the cost of election campaigns mushroomed and as PACs were unleashed on the world, some members found that it was even more fruitful to keep the pot constantly boiling than to legislate benefits. Ironically, proposing unpopular tax reforms was often as effective in raising contributions as proposing benefits. Some Congressmen have been accused of raising to an art the process of collecting large sums from industries they were simultaneously attacking, a paradox made possible because many companies felt they could not afford to offend the ringmaster in their ring.

• **The declining share of corporate section revenues: The Reagan revolution and counter-revolution.** A fifth factor was that the share of revenues that came from the corporate sector was declining. Much of that decline had to do with the fact that the corporate sector was itself declining as a percentage of the whole economy and that corporate profits were, furthermore, being squeezed. This was particularly true during periods of high inflation. The trend was greatly accelerated by the first Reagan Revenue Act in 1981, which escalated depreciation deductions far beyond any realistic concepts of economic depreciation. The result was to reduce still further the declining share of revenues represented by the corporate sector. The Revenue Acts of 1982, 1984 and 1986 have been chipping away at what the 1981 Act did. You can think of the last six years, if you will, as a Reagan revolution followed by three counter-revolutions.

• **Voter appeal (?).** Finally, the reform movement has been fueled by the persistent belief that it has voter appeal. It clearly does for some Congressmen and some constituencies. It seems doubtful, however, that it has broad appeal, although in recent years each new administration appears to have started out believing that it does.

The Future Outlook

What does the future hold?

You will note that several of the factors responsible for the reform movement in the past continue today. Academic economists are still focused on growth, rules proliferation and the breeder reactor effect continue exponentially, as the present revenue act attests, and PACs are alive and well. On the other hand, the decline in the share of revenues from the corporate sector has been reversed, but the share is still less than it once was. Whether tax reform will be thought to have political appeal after the current Act remains to be seen.

Bracket indexing and the budget deficit: A whole new world

The one enormous change has been a change in the most important of the factors responsible for past change, namely, inflation and the fiscal dividend. Inflation has not, of course, disappeared; it just seems to have disappeared in comparison with the stratospheric levels attained in the 1970's. What has changed, however, is the bracket indexing adopted in the 1981 Act. Curiously, this was not a Reagan proposal. It was inserted by the Congress and was for a number of months an unloved child, though subsequently it was warmly adopted and stoutly defended. It has radically changed the picture. Real growth in incomes still pushes taxable income into progressively higher brackets, but inflationary increases in money incomes alone no longer do so.

In any event, Congress no longer has the fiscal dividend to play with, and if it is true, as conventional wisdom holds, that tax reform is possible only in the context of tax reduction, the future holds no revenues to fund reduction, and reform activity is likely to be much dampened. It is true that, in this particular bill, we did have tax reform while professing to have revenue tax neutrality rather than tax reduction. But in fact, we had tax reduction for voters by having tax increases for corporations. But there is a limit to the amount by which corporate revenues can be ratcheted upwards, and it seems doubtful that this tactic will work again.

Instability in the new law

Notwithstanding that there are no automatic revenues on the horizon with which to fund reductions, the new law seems inherently unstable politically. The 1981 Act was predictably unstable politically because it gave so much to corporations, leaving them ostensibly subject to an income tax but with a minimal tax burden.

The 1986 Act has a similar defect, probably. Virtually no one alive today can remember top marginal rates as low as 28% for individuals and 34% for corporations. You can predict as well as I whether maximum rates that low have a reasonable chance of surviving in a populist climate in which most voters were taught "at their mother's knee" that the key to tax justice is "ability to pay."

A second instability relates to the issue of capital gains. Capital gains are now taxed at the same rates as ordinary income, a fact which many voters regard as contrary to natural law, although capital gains have been taxed in the past at higher absolute rates than under the new law. If marginal rates are in fact raised in the future, the feelings of injustice will become acute and the treatment of capital gains as ordinary income is likely to unravel, pulling with it other related provisions.

An even more serious instability is the existence of a budget deficit generally viewed as unacceptably large—which

creates pressure for tax change—and the fact that the present bill is likely to increase the deficit still further. The present bill is said to be revenue neutral over the next five years, that is, the revenue gains caused by the bill will about cancel out the revenue losses. Arrayed in tables, the official revenue estimates look authoritative, just as computer printouts look authoritative. But they are estimates, in most cases estimates of the shakiest sort. They are like sausages. If everyone saw how they were made, no one would swallow them. My own judgment is that the estimates probably substantially overstate the revenue gain, particularly in the out years. In fact, we will never know, because it is impossible even in retrospect to measure the revenues we would have had if we had not done what we did. But if it is true that there is an overestimate of revenue gain, the deficit problem will become even more frightening and the pressure for revenue increases of some kind even more compelling.

A final instability arises from the sheer multiplicity of the changes. A bill so large, with so many details, is bound to have a large number of technical glitches and even if technically correct, to cause a large number of economic dislocations in particular companies and industries. There will inevitably be considerable turmoil as these things are ironed out over several years and a continuing demand for corrective legislation.

Special Aspects of this Round of "Reform"

I would like to comment next on three special broad aspects of this round of reform.

First is the question, where does tax reform fit in the Administration's overall strategy in the budget battle?

It is clear, however, that shrinking the relative size of the government sector in the total economy has been a central theme of this Administration. A substantial school of political thought, led most prominently by Milton Friedman, holds that the greatest hope presently available for holding down the government sector is to starve it of revenues. Friedman is perhaps the most eloquent spokesman for the view that the Congress will spend whatever is available and a little bit more, and that the deficit will remain about the same—namely, at the highest level politically tolerable—no matter what revenues are collected. Not everyone believes that theory, but we are clearly giving it a good test.

Whether intentional or not, the current tax reform exercise, with its insistence on revenue neutrality, has implemented this approach. The revenue neutrality requirement was recognized early by the reformers as a political prerequisite to obtaining reform. The political pain of reform was tolerable to the tax writers only if it could be seen as directly funding tax reduction. And you will remember that even that did not work very well, and the whole effort nearly collapsed until the Senate made the rate reductions so dramatic that they overwhelmed opposition to the reform aspects. Reform for the sake of reform or for the abstract aim of narrowing the deficit was a political nonstarter. Thus, those who were committed to tax reform came early to view revenue neutrality as the engine that would produce it.

So long as reform was the order of the day in Congress it forestalled an increase in taxes generally. While there was a small vocal group that sought to add tax increases to the reform package, the more general congressional reaction was that any attempt to increase taxes would invoke White House opposition, undercut the pressure for reform and cause the whole reform effort to unravel.

Thus, history may well view the tax bill as a brilliant and successful strategy to co-opt the liberal reform elements, to prevent an increase in the tax burden and to starve successfully the growth of the government sector. Whether that result was intentional or accidental may never be truly discovered.

Whatever has happened to progressivity?

Traditionally, liberal tax reformers have sought to close loopholes and broaden the tax base in order to make the tax more progressive. This time around the liberal tax reformers jumped into bed with conservative reformers, whose primary aim was to make the rates less progressive. Does the bill increase progressivity or does it not? Which group out-foxed the other?

The first thing to note is that one can't accurately answer the progressivity question by looking solely at the individual income tax. The overall bill is officially estimated to be revenue neutral. But neutrality is the result of an estimated reduction of \$120 billion in the individual income tax accompanied by a like increase in the corporate income tax. While corporations send in tax checks to the IRS, it is, ultimately, individuals who bear the burden of that tax. No attempt was made in the official figures to estimate the distribution of that burden among the individuals who ultimately bear it. That is in part because there is no agreement among economists as to which persons do bear the burden of the corporate tax. That is one of the chief criticisms leveled at the tax, that it is not clear on whom it really falls. The dominant view in recent years seems to be that it falls generally on the owners of capital (as distinguished from the shareholders of a particular corporation or the shareholders of corporations generally) in the form of lower gross returns on capital investments. The owners of capital tend to fall in the upper-income brackets, and if the burden of the corporate tax falls on them, then the corporate increases will operate as invisible offsets to the visible reductions in individual tax for these upper-bracket individuals.

Clearly, there are net reductions in tax for lower-bracket taxpayers which, though small on a per capita basis, are large in aggregate. If it is correct that the bill is neutral overall and that lower-bracket individuals clearly have substantial reduction in their individual income tax and do not bear a significant portion of the corporate tax burden, then upper-bracket taxpayers must have a net increase in tax burden. In that sense—and to that extent—the effect of the bill can be said to be progressive, i.e., lower-bracket taxpayers will pay less tax and upper-bracket taxpayers will bear a larger tax burden (some of which will not be reflected in the individual income taxes they pay).

At the same time, however, the end result will be a rate system that is less steeply progressive than present law. The increases will be very substantial for many high-bracket taxpayers who have been deeply sheltered and are currently paying at low effective tax rates. But there will be dramatic—and visible—reductions for perhaps an even larger group of high-income taxpayers whose real rates correspond closely to statutory rates, for their top marginal rates will drop from 50% to 28%. They are the only taxpayers who will have really significant dollar reductions in their direct tax liabilities.

But even that is not the whole story, for the revenue estimates may not be reliable, or at a minimum, need to be interpreted with care. The shift from individual tax to corporate tax may not be as indicated.

There is, I think, pretty much agreement among economists at both ends of the political spectrum that it is the *marginal* tax rates which have the greatest effect on taxpayer behavior and economic efficiency. Lower marginal rates would enhance efficiency. But most members of the tax reform wing have believed that efficiency aim to be subordinate to the need for progressivity, which they have regarded as a keystone of political fairness.

Eliminating the capital gains preference has been touted by the reform group as perhaps the greatest achievement of the new Act. But, ironically, it has been achieved, not by making the rates more progressive, but by bringing the rates on regular income down to what used to be capital gains rates.

Eliminating the capital gains preference was important in the effort to make the changes in individual taxes appear nonregressive in the upper brackets. There is widespread suspicion among trained observers that the revenue pick-ups from capital gains were over-generously estimated in order to make the income distribution tables appear nonregressive. If these estimates are in fact too high, the net dollar benefit to higher-income taxpayers is greater than publicly indicated (because the revenue pick-up in those brackets is underestimated).

In addition, the income distribution tables fail to take into account the fact that an increase in the tax liability of a taxpayer who is an investor may not be a *net* detriment because, as the tax increases, there is often an offsetting benefit. This effect can be seen most easily in the case of an investor in municipal bonds. Suppose that the interest rate spread between municipal bonds and taxable bonds is 30%, which it roughly was for many years, so that if a taxable bond produces \$10 of interest income, a comparable municipal bond produces \$7 of interest income. If a 50% taxpayer owns a municipal bond, he gets to keep the full \$7 but if he owns a taxable bond, he gets to keep only \$5. The municipal bond is said in economists' terms to carry an "implicit tax" of 30%, that is, its \$7 yield is 30% less than the \$10 before-tax yield on the taxable bond. If the tax rules are changed so that holding a municipal bond becomes uneconomic and the taxpayer switches to the \$10 taxable bond, the income distribution tables will show him as paying \$5 additional tax. However, he is in fact only \$2 worse off because there was an implicit 30% tax on the municipal bond.

There is a lot of that kind of effect in the current tax bill. The provisions for disallowing passive losses and the minimum tax are examples. They are shown as producing very large revenue pickups from high-income taxpayers, and it is true that those taxpayers will change their behavior and pay more direct tax, but it is also true that the net additional burden that will be imposed on them will be substantially less than the additional tax they remit because they will be simultaneously relieved of an implicit tax they are now paying.

The net result of all this is that, looking at the individual income tax *only*, progressivity has probably been very substantially reduced, and the real reductions for high-bracket taxpayers may be considerably greater than officially indicated. When the corporate changes are also considered, the picture shifts and the Act appears to be progressive in effect. But it is only the individual income tax that the layman focuses on, and if big and highly visible reductions there turn up in the upper brackets, that will, I suggest, be a further instability.

Simplification

Simplification was a much advertised goal in the current round of tax reform. There is not much talk about simplification at this point, but some did occur.

An estimated 6 million taxpayers were deleted from the tax rolls by increasing the personal exemption. More accurately, they were deleted *again* from the tax rolls. This deletion happens every time there is a new round of tax legislation. In the interim since the last legislation, rising real incomes, especially when combined with inflation, push taxpayers deleted from the tax rolls the last time around back into the lower brackets. It is part of the political ritual in every tax bill to delete them again. That is undeniably simplification of a sort, but it is not any kind of major breakthrough.

One real simplifying change concerns the deductions for state and local sales taxes and the so-called "miscellaneous" deductions. To compute those deductions correctly, the taxpayer had to keep a whole shoebox of receipts and records for small daily expenditures. The sales tax deduction has been completely eliminated and the miscellaneous deduction had been practically eliminated for most taxpayers by making it deductible only to the extent it exceeds 2% of the taxpayer's adjusted gross income. This change is probably the most meaningful simplification for ordinary taxpayers.

Of course, the hard, sad fact is that a great proportion of ordinary taxpayers are terrified of anything that involves arithmetic, no matter how simple we make it for them. Those taxpayers are going to go to H. & R. Block, no matter how simple the law becomes.

Much has been made of the fact that the tax rates are lower and that there are only three rate brackets. That is a good thing, but it is not meaningful simplification. It is symbolism that played well in the newspapers, but it is largely without substance. The fact that there are a number of rate brackets under existing law does not complicate anything because the taxpayer does not use all of those brackets. After he has computed his taxable income, he goes to the tables in the instruction form and uses only the top bracket in which his income number falls or simply gets the number directly from a table without any reference to rate brackets.

Ruling Symbolisms

There were two overriding ideas, symbolisms if you will, that dictated the specifics of much of what was done in the bill.

Low Effective Rates

The first had to do with the fact that a number of taxpayers with substantial incomes paid relatively low taxes—taxes substantially lower than would be indicated by the rate tables. This has been widely publicized for the last 15 years in the case of corporations, and everyone knows or thinks he knows a dentist or a doctor who purports to shelter his income.

In tax terminology, we refer to this phenomenon as "low effective rates" of tax. Low effective rates have been commonly misperceived as a fairness issue. In fact, this condition is not a significant fairness issue, but rather a resource allocation issue. Taxpayers who shelter their income with legitimate deductions and credits from investment activities generally find that the tax reduction has been at the expense of a lesser gross yield, just as the owner of municipal bonds pays no tax, but accepts a lesser yield than he would get on

taxable securities. In the case of municipal bonds, there is still a little gravy there for the high-bracket taxpayer, but that appears to be less true in the case of more speculative investments and largely untrue in the case of corporations. Many of the corporations that have the greatest shelter are among the least profitable. Nonetheless, after 15 years of drum beating on this effective rate issue, Congress—and the staff—was determined to stamp out this appearance problem. It was unwilling, however, to eliminate the fundamental causes and enacted a complex set of appearance provisions which do not eliminate “tax shelter” but simply cause less of it to meet the eye.

Uneconomic Investments

One of the comments I hear constantly is that the old tax law caused many uneconomic investments to be made, that it encouraged people to do things for tax reasons alone, and that the new law will surely stop all that.

There is a kernel of truth in that thought, but it is a much smaller kernel than most people realize.

In many cases our tax system seems to *give back* taxes with respect to new investments. In the case of so-called tax shelters, it sometimes appeared that some investors got nothing but tax reductions or refunds. But that did not mean that the projects as a whole were uneconomic.

The appearance problem arises really from two phenomena. The first is that we have used generous depreciation rules and the investment tax credit, as well as the capital gains preference, as relatively simple and rough devices to offset the overstatement of income that is caused by an accounting system that fails to take account of inflation. You are all familiar with the fact that if you buy a house today for \$100,000 and there is 100% inflation and then you sell the house for \$200,000, you are really no better off. However, the tax system overstates your gain. It gives you \$100,000 of taxable income. The same phenomenon occurs in connection with business investments. If you buy a new machine that lasts for a number of years, you are in effect selling it in pieces year-by-year as you use it up in the production of the objects that are sold. In the absence of indexing, the tax accounting system mismeasures income in an inflationary period by counting as income amounts that are not really income.

The greatly accelerated depreciation rules and the investment tax credits are rough offsets to that process. They provide in most cases a tax benefit at the front end of an investment—a reduction or refund in tax—which offsets the tax which is paid at the back end of the investment. In recent years they have probably overdone it somewhat, and it is arguable that at lower rates of inflation, present rules in effect give back as much—or more—tax at the front end as they collect at the back end. But the basic point is that the front end tax benefits must be viewed as part of a transaction occurring over longer periods of time and when so viewed are only offsets to what would otherwise be excessive taxes.

Secondly, it is simply not meaningful—or at any rate it is misleading—to speak of tax rules as causing people to make investments that are “uneconomic.” One cannot determine what is or isn’t “economic” without regard to taxes—they are a part of the cost of any project. It is arguable that in selected cases the tax rules may produce the equivalent of a “negative tax,” i.e., that they produce net income rather than net cost. But those are special cases and they cannot be identified by looking at only a single investor in a project.

There are a great many cases where the items of income and cost, including taxes, are allocated among investors in a project in such a way that some of the investors would not have a profit but for the tax attributes allocated to them. The casual observer often concludes from that fact that the project is “uneconomic.” But that is seldom the case. The existence of such an investor reflects only the method of financing the project, and in order to tell whether the project itself is economic, it is necessary to aggregate the cost and income flows of all the investors in the project.

The Big Changes in Structure

There are three big structural changes of particular importance to business.

Complexity in distinctions among classes of income and deduction

First the new law will produce an almost incredible array of distinctions among kinds of income and deductions and the entities in which they occur, which are dictated by the new rules with respect to passive investment, the new alternative minimum tax provisions and the restrictions on interest.

All of these were motivated by the desire to deal with the appearance problem of low effective rates. The result is *overwhelming* complexity.

That will discourage entrepreneurial investments by individuals. In order to avoid tax penalties the investor must engage in a very sophisticated program of mixing and matching with each other different kinds of investments and entities. In the kinds of investment affected, the complexity will be overwhelming. It will be *too much* for most individual investors. It will simply take them out of this particular segment of the capital marketplace. As a result, it will deprive many enterprises of access to their traditional funding sources. Investment activities affected will be driven out of the hands of individuals and into the hands of corporations or of middlemen entities that are staffed with people and equipped with computers adequately to handle the complexities.

At the corporate level the same kinds of problems will be presented. Activities must be carried on in the proper mix within each corporate entity, in order to avoid stiff tax penalties. Most corporations can gear up to deal with this kind of problem, but it will be complicated and expensive. The new rules will lead to a great variety of acquisitions, combinations, dispositions and other restructuring in order to end up with the proper mix and to maintain the proper mix as conditions change from year to year.

Inversion of the top corporate/individual rates

A second major structural change is the inversion of the top corporate rate and the top individual rate. This is the first time in history that the top corporate rate will be higher than the top individual rate.

The first and most obvious result of this change is that it will make the corporate double tax much more oppressive. The double tax occurs because income is taxed twice, once at the corporate level and again when distributed to stockholders. Under present law the corporate rate is lower than the individual stockholder rate. For many years it was much lower. So long as income was not distributed it was clearly cheaper to be in corporate form. The second tax at the stock-

holder level was often never paid because the profits were never distributed to or realized by the shareholder; or was deferred for long periods of time because there was a long delay between the time profits were taxed at the corporate level and the time they were distributed; or was levied ultimately at capital gains rates, because the shareholder cashed out his investment by selling the stock. As a result, under present law, the economic burden of the second tax has been greatly diminished if not entirely avoided and the so-called double tax has in fact often been less expensive than if the corporate income had been originally taxed directly to the shareholders at higher rates.

Under the new law this will no longer be the case. The initial first level tax at the corporate level will exceed the individual shareholder tax, right from the beginning. When the second tax occurs at the shareholder level, it will further compound that excess.

The result of this shift is that corporate debt will become relatively more desirable even than it has been. That is because when investment in corporations is made in the form of debt, the gross income from that investment will be channeled immediately and directly through the corporate entity to the individual investor. That not only removes the double tax—as it did under prior law—but it causes the income to be taxed directly to distributees whose 28% or less average marginal rate is much lower than the 34% corporate rate.

That same rate inversion will change the basic economics of deferred compensation. Under present law, \$100 of deferred compensation costs the corporation \$46 initially, because it cannot be deducted currently. But it saves the recipient perhaps \$50 currently, so that vis-a-vis the government the parties are at least \$4 ahead. Under the new law, failure to pay the compensation currently will cost the corporation \$34, but will only save the individual \$28, so that vis-a-vis the government the parties are \$6 behind. You can expect to see a lot of creative activity designed to change compensation plans in a way that permits the parties to pick up that \$6 from the government.

Another consequence of the inversion of the rate structure is that it will create major incentives to restructure corporate activities into some kind of conduit entity, such as a partnership, trust or S corporation, which will permit the income to flow directly to the individual investors. The royalty trust was such a device under the old law; incentives for such devices will be much greater under the new law. That kind of restructuring will be viewed with alarm by many as a new loophole, and you can expect to see legislative attention and new sets of rules designed to limit it. In fact, the Ways and Means Committee has already announced that it intends to study the subject of so-called conduit entities.

Shift to Business

A third major structural change comes from the major shift of the tax burden to business. \$120 billion over 5 years in extra corporate taxes is the official estimate. In addition, the increased tax on capital gains is essentially a tax on business. I have already explained that in our tax accounting system inflation causes business income and capital gain to be overstated and, thus, overtaxed, and that the depreciation rules, investment credit and capital gains exclusion have operated roughly to mitigate that fact. But it is the removal of those very items that accounts for much of the increase in business taxes. The new bill is eliminating some of the important fuse breakers that have helped keep inflation from overloading the circuits. While inflation is down from the level of a few

years ago, it is still high by historical standards and high enough to create major distortions in the case of assets held for a significant number of years.

Major Income Tax Legislation Since World War II

Revenue Act of 1948	Tax reduction from wartime levels.
Revenue Act of 1950	Korean War: restored wartime rates, tightened rules for life insurance and exempt organizations.
Excess Profits Tax Act of 1950	Korean War.
Revenue Act of 1951	Further rate increases, numerous special provisions.
Internal Revenue Code of 1954	Extensive rewriting of Code, retaining basic structure but adding many new provisions; slight revenue reduction.
Revenue Act of 1962	Emphasis on investment: enactment of Investment Tax Credit, modest revenue reduction.
Revenue Act of 1964	Major tax reduction and base broadening proposed; major tax reduction adopted, primarily in individual rates; tax base eroded.
Tax Adjustment Act of 1966	Graduated withholding, changes in payments. No changes in liabilities.
Revenue and Expenditure Control Act of 1968	Surplus, major revenue to lessen large deficits, no reform.
Tax Reform Act of 1969	Major "reforms," modest revenue loss; reform items account for more changes than rate reductions, ITC repealed.
Revenue Act of 1971	Tax reduction to respond to economic conditions, ITC reinstated, DISC, depreciation liberalized.
Employee Retirement Income Security Act of 1974 (ERISA)	Extensive changes in pension provisions, IRA's enacted.
Tax Reduction Act of 1975	Major tax reduction responding to recession & inflation; ITC increased, depletion allowances curtailed.
Tax Reform Act of 1976	Numerous "reform" revisions, responding to "reform" proposals under consideration since 1973; focus on tax shelters; little net revenue changes other than from extensions of expiring reductions.
Tax Reduction and Simplification Act of 1977	Major reductions; wide variety of new jobs credit, "tailoring" of incentives, not much "reform."
Revenue Act of 1978	Major tax reductions; many changes both increasing and reducing tax, emphasis on capital formation; rejected major base broadening reforms advanced by Carter Administration.
Crude Oil Windfall Profit Tax Act of 1980	Major revenue gain predicted; repealed carryover of basis at death.
Economic Recovery Tax Act of 1981	Largest tax cut in history for both individuals and corporations. Major increases in depreciation allowance; IRA's extended to everyone; bracket indexing; reduction of top rate to 50%.
Tax Equity and Fiscal Responsibility Act of 1982	Reversed part of 1981 reductions, numerous substantive revisions; significant revenue gain.
Deficit Reduction Act of 1984	Substantial revenue raiser; many substantive changes; further reduction in depreciation allowances; emphasis on time value of money.

(FEDERAL DEFICIT, from page 1)

more—to \$2.323 trillion—to pay the government's obligations through September 30, 1987. But the Senate hung more than two dozen extraneous amendments on its bill, including a controversial plan to restore the automatic budget-cutting provisions of the Gramm-Rudman-Hollings law, struck down in July by the Supreme Court. Consequently, the measure died.

1987 Deficit Level Uncertain

No one knows exactly how much the 1987 deficit will total or how high the legal debt ceiling will have to be to cover next year's borrowings. Fiscal year 1986, which ended September 30, was a big year for red ink. Washington recorded the largest deficit ever—\$220.7 billion—and the largest interest bill ever run up by the U.S. government—\$135.3 billion. As of August 20, the Office of Management and Budget (OMB) estimated the 1987 deficit at \$156.2 billion, while the Congressional Budget Office (CBO) placed it at \$170.6 billion.

Why does the debt ceiling continue to soar higher than the American eagle? Presumably people want—or their elected officials believe they want—government benefits now, leaving to future generations of taxpayers the burden of paying the bills.

Certainly, over the last decade, the upward motion has been unrelenting. Gross debt of the U.S. government passed \$500 billion in 1975. By 1982, it had doubled, topping the \$1 trillion level for the first time. In just four more years, it doubled again, passing \$2 trillion in 1986.

The black hole of debt grows ever faster as interest charges on existing debt increase and the principal remains unpaid. More and more new debt is required just to pay the interest charges on old debt. The process takes on the appearance of a galactic implosion.

Interest Costs Also Soar

Net interest payments rose from \$29.9 billion in 1977 to \$138.9 billion in 1986, and now equal more than 60 percent of the annual deficit and about 40 percent of yearly individual income tax collections.

Interest costs in 1987 are estimated at \$140.9 billion. They will consume 15.3 percent of total budget outlays, up from 8.9 percent at the start of the decade.

Since 1980, interest has been the fastest growing segment of the Federal budget. Net interest payments have

(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation

"Writing Tax Laws with Newspeak"

George Orwell would be delighted. The U.S. Congress is slipping more and more into the Orwellian mode, of turning language upside down so no one, except a self-perpetuating elite can know what really is going on.

Orwell's disturbing vision was presented in his novel, "1984," a fictional account of life in a police state carried to its ultimate absurdity, where thought itself was to be controlled. Language, the handmaiden of thought, thus had to be also subverted to serve the state. The masters' method: reverse the meaning of words, as in "War is Peace."

The U.S. Congress is a long way from that, but it's headed in that direction. The "transition rules" of the 1986 Tax Reform Act, and the way they were inserted in what started out to be a "simpler" tax code, offer the latest case of newspeak in national legislation.

Chaotic procedures and impenetrable language are becoming a congressional trademark. Tax transition rules started out, years ago, as temporary exemptions from new law to prevent unjust or unwise hits on certain individuals or groups. In 1986, hundreds of transition rules became the bargaining chips in deals negotiated privately by a few congressional leaders and their staffers.

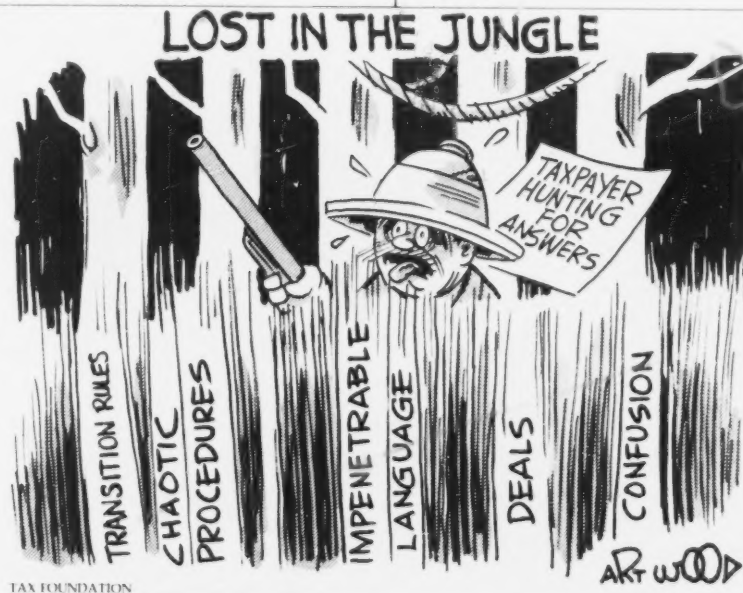
The result was page after page of statutory language so convoluted that even

the authors could not understand it. Ludicrous errors—a rule intended for Pensacola, Fla., reportedly benefitted New Orleans, instead—and typographical glitches marred the final version. So an immediate "technical corrections" bill was thrown together, but it became festooned with still more transition rules.

In yet another contretemps, language voted in a budget reconciliation measure contradicted Tax Reform Act language on an understatement of tax penalty. President Reagan signed the budget act first, which meant that it was overruled by the later law, the Tax Reform Act. "Not to worry," said the Treasury Department, in effect, "we will have IRS issue a statement effectively switching the order in which the laws were signed for purposes of this provision. We'll straighten it out in 1987."

With newspeak, anything is possible. That's why the approach is spilling over into all kinds of other legislation and Federal agency regulations. Newspeak is addictive because it greases the way for slipping a controversial idea past opponents since no one—except a few insiders—knows the real meaning of the words used.

Let's bring tax and other laws back to the people. KILL NEWSPEAK! Before it strangles us.



TAX FOUNDATION

(FEDERAL DEFICIT, from page 3)

shot up at an average annual rate of 18.0 percent. (Net interest represents interest paid by the government less interest received on debt held by Federal agencies and accounts.) In comparison, noninterest outlays have risen by less than 7.4 percent a year and receipts at slightly over 7.0 percent annually. The debt itself has grown at a 15.2 percent annual rate.

Increases in the statutory debt limit are typically larger than the expected deficit in a given year, because the debt ceiling also allows for increases in debt sold to trust funds whose surpluses must (by law) be invested in public debt securities.

A History of Upward Growth

The legal debt ceiling has a history of relentlessness in its upward climb. From 1947 through February 1958 the statutory debt limit remained at \$275 billion. But since then Congress has raised the limit nearly every year.

In 1971 Congress enacted a new permanent limit at \$400 billion. All increases from then until 1983 were supposedly temporary increases for limited time periods, as were most increases leading up to 1971.

In 1983, Congress partially faced up to reality and raised the permanent limit to \$1,389.0 billion, the sum of the \$400 billion permanent limit then in effect plus the temporary limit of \$989.0 billion. It eliminated the distinction between the permanent and temporary limits for a while. But now we are headed back on the same old double-speak track of "temporary" increases.

The table on page 1 provides further details on Federal deficits for selected fiscal years 1977-1987.

TF Program for 1986 Will Track Impact Of '86 Tax Act and G-R-H Budget Checks

Efforts to duck or water down the constraints of the Gramm-Rudman-Hollings deficit reduction measure will keep Tax Foundation analysts busy throughout the coming year. The Foundation's "Program for 1987," recently approved for implementation by the Board of Trustees, takes aim at spending levels and the overall budget process, characterizing "truth in budgeting" as a "scarce commodity" in 1986.

"Large Federal deficits in 1987," the program charges, "will unmask last year's 'deficit reduction' activity as little more than 'blue smoke and mirrors.' Congress will be forced to comply with the Gramm-Rudman-Hollings target, or junk the whole process."

Shadow Budget Committee

A primary actor in this budget-watching will be the Shadow Committee on the Federal Budget, a citizen's oversight group established by the Foundation's Trustees in December 1985. The Shadow Budget Committee will continue during the coming year to analyze the evolution of the budget process, starting with the President's Budget for Fiscal 1988, due for release in January.

Committee members will continue to meet with top Administration, Congressional and media officials in an effort to keep budgetary policy on track. They will also begin laying the foundations of a major public conference on the budget process, designed to "bring together public officials, educators, corporate executives and media

representatives from the highest levels of government, business and the private sector."

Taxes Bear Watching, Too

Taxes—specifically, taxes to compensate for spending cuts Congress is unwilling or unlikely to make—will also come under close scrutiny by policy analysts at the Washington-based watchdog organization. As the Tax Reform Act of 1986 begins to phase in, Tax Foundation policy-watchers say, "Chances are high that it will produce effects that were neither intended nor anticipated when the bill was forged in the legislative process." Because of unplanned economic dislocations and because continuing large deficits cloud the horizon, the Foundation warns, the Federal government can be expected to be continually involved in tax legislation proposals.

The Foundation's program does foresee a greater focus on tax action among the states. "There is a growing shift of responsibility for devising, funding and implementing programs from Washington to the states and localities," the program notes. "Tax Foundation analysts will continue to monitor and report on this change in the balance of intergovernmental relations and the growth of taxes at the state-local levels that it will inevitably entail."

Though there may be "fewer headlines," the Foundation also intends to monitor closely a number of anticipated tax moves during 1987.



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TAX·FEATURES

FY88 Budget Proposes \$40 Billion Cut To Meet G-R-H Target of \$108 Billion

Modified Freeze Could Balance Budget by 1990 Domenici Tells TF Dinner

A "modified freeze" would put the U.S. within \$20 billion of the Gramm-Rudman-Hollings deficit reduction target for fiscal year 1988 and would balance the budget by 1990, Senator Pete V. Domenici told Tax Foundation's Annual Dinner December 3. Delivering a major policy address after receiving the Foundation's Distinguished Public Service Award for 1986, the Senior Senator from New Mexico and Ranking Republican on the Senate Budget Committee told the Dinner attendees that such goals were "clearly achievable" on a current policy basis, "absent a disaster or a catastrophe."

The "modified freeze" proposed by Domenici included recognizing that "American servicemen and American civilian workers ought to get a pay increase every year; and realizing that 'the fight against automatic cost-of-living increases is gone' because 'it's political dynamite,'" Domenici said. "So give everybody their cost-of-living index increase and freeze everything else at today's levels. Don't cut it; just freeze it—a literal freeze."

While working toward the budgetary balance his "modified freeze" promised, Domenici also called for facing up to a number of "serious problems":

- There may be need for \$5 or \$10 billion in additional funds to pay for needed defense outlays. "If they truly need [the additional funds], lay it on the line and say that's an exceptional add-on and it's got to be paid for, even if it means revenues," he said.

- The welfare program currently on the books "does not meet the social problems of today." Among these, the Senator listed the more serious issue of "the single head of household," and the "homeless issue," because "this country is too good and its people are too decent" to let the problem continue unmet.

- Domenici also cited the need for additional research and development to promote competitiveness, health care for the elderly, and what he described as "the incredible infrastructure dilemma of the cities and counties and states."

Some of the funds to pay for these programs, Domenici charged, could be obtained by trading up and trading out funds for programs still on the books

(Continued on page 4)

President Reagan's fiscal 1988 budget promises unprecedented success in reducing the deficit. If the new budget is to be believed, the deficit would be cut in half in two years, from more than \$220 billion in fiscal 1986 to less than \$110 billion in the 1988 fiscal year. The Administration would meet the Gramm-Rudman-Hollings (GRH) deficit target without significant tax increases and with fewer spending cuts than were sought in previous Reagan budgets.

The Political Arithmetic of Deficit Reduction

How does the President promise to cut the deficit without new taxes and with a continued defense buildup? Part of the answer lies in the budget's policy recommendations, part in its economic assumptions. The table on page 2 shows the path taken by the Administration to meet the GRH deficit target. Beginning with fiscal 1987 spending a bit above the trillion dollar mark, the budget estimates that expenditures would rise another \$45 billion if existing policies under "current services" were continued in effect. (The current services budget estimates the amount it would cost to maintain current policy in future years with expected price and workload changes in existing programs but with no spending policy or tax initiatives.) Most of this increase would be concentrated in the two fastest-growing sectors of the budget. Social Security and defense. The first is off limits to budget cutters; the second has strong presidential support for additional funds. Big spending increases also would occur—even if no programs were changed—in other difficult-to-control areas of the budget such as interest costs, Medicare, and other mandatory payments. Only about one-tenth of the current services increases are estimated to occur in the "discretionary," nondefense operations of the Federal government.

On a current services basis, the budget estimates that about \$40 billion will have to be pared from the deficit to meet the GRH target of \$108 billion. A more realistic computation might show the deficit \$60 billion or more above that level.

The proposed fiscal 1988 deficit reduction leans heavily on the revenue side of the budget. While publicly warring against any and all tax increases, the budget expects to generate \$8 billion in additional revenue plus \$3 billion in user fees, and about \$10 billion in income from the sale of government assets.

The budget lists about \$20 billion in proposed

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"Back Door Tax Hike"

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spending cutbacks, but few of these have much chance of enactment. The biggest savings are sought in Medicare, a program that has had an uncanny ability to grow year after year despite the huge cuts reputedly made in it. And the cuts in farm, low-income, and social programs obviously will encounter strong opposition in Congress.

The Economic Outlook

The fate of deficit reduction depends not only on what Congress does to the budget but also on the performance of the economy. **Rosy scenario**—the label for **unduly optimistic forecasts that show the budget deficit shrinking as the economy grows**—is a bit more modest this time around. Compared to past predictions in the 4 percent range, this year's 3.1 percent forecast for real growth in GNP might well be within reach. But there are a number of soft spots in the economic outlook that could cause performance to be weaker and the deficit to be correspondingly higher.

Federal revenues are highly sensitive to economic conditions. A small shortfall in growth can translate to a substantial drop in revenue. It is something of an anomaly for the Administration to

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First Boston's Chief Economist Wojnilower Sees Modest Economic Growth in 1987

"Less of the same" was the economic forecast delivered by Albert M. Wojnilower, managing director and chief economist for the First Boston Corporation, in his keynote speech at Tax Foundation's 38th National Conference. He detailed this basic repetition of 1986's economic scenario as:

- 2 ½ percent real growth;
- fewer industrial and regional disparities;
- smaller, but not much smaller, budget and trade deficits; and
- lesser declines in interest rates and the dollar—but still declines, as compared with before.

"If this forecast is wrong," Wojnilower told the 325 business executives, academicians and media representatives present at the conference, "it's going to be wrong not because we have a boom, but because we can't even achieve the 2 ½ percent."

Deficits and Interest Rates

Wojnilower took issue with those who claim that high deficits portend high interest rates. "The large budget

deficits in the economic context in which we have been living," he observed, "have not made interest rates higher than they otherwise would have been. Nor have they made the dollar higher than it would otherwise have been."

In fact, claimed Wojnilower, "despite sharply rising budget deficits, interest rates have collapsed, and in the last year and a half or so, the dollar has also collapsed." In essence, the economy "has not experienced any significant change of pace" for more than two years, he said.

Levelling Off

While the weaker sectors have been "bottoming out," Wojnilower said, "the stronger sectors have been tapering off." He predicted that "the 2 ½ percent type of growth is likely to continue," but forecast a decrease in the "disparities in performance among regions and industries." Consumption "will continue to provide an anchor to the economy," he said.

Along with modest growth in the economy, Wojnilower also predicted modest growth in inflation to "between 3 and 4 percent," assuming not much happens to oil prices. He also saw further declines in interest rates and in the value of the dollar, "but not nearly with the same intensity." He saw "a decline—or maybe more than one—in the discount rate" during 1987.

"We are not on the edge of a boom," he concluded. "We are not on the edge of anything."

The Arithmetic of Proposed Deficit Reduction (\$ bils.)

Fiscal 1987 Outlays	\$1,015.6	
1988 Current Services Increases (net basis)		
National Defense	15.4	
Social Security	11.6	
Medicare	6.6	
Income Security	4.5	
Interest	2.4	
Other Functions	4.4	
1988 Current Services Outlays	\$1,060.5	
1988 Current Service Revenues	910.4	
1988 Current Services Deficit		\$ 150.1
Proposed Revenue Increases and Spending Reductions (net basis)		
Revenue Increases		
User Fees	3.2	
Other Revenue Increases	8.2	
	11.4	
Asset Sales		
Loan Asset Sales	5.5	
Other Asset Sales	5.0	
	10.5	
Spending Reductions		
Health Programs	7.4	
Agricultural Rural	2.5	
Low-Income Programs	3.1	
Education Programs	2.9	
Other Social and Income Programs	2.6	
Other Reductions	2.0	
	20.5	
Total Deficit Reductions		\$ 42.4
Proposed 1988 Budget Deficit		\$ 107.8

Source: Fiscal 1988 Budget of the U.S. and Tax Foundation calculations.

Tax Features

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FEDERAL TAX POLICY MEMO

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Congress and the Workplace

By Frank B. McArdle

The second session of the 99th Congress adjourned October 18, 1986. In many ways, it was a remarkable Congress. Tax reform was of course its crowning achievement. But this last session was equally important for other pieces of legislation passed or considered.

How is it that Congress, in passing tax reform, sought to lighten the load of government and of tax considerations on private-sector decisions, and ended up involving itself ever more deeply in the workplace, particularly with respect to retirement income, health insurance, and other voluntary employee benefit matters?

What Does Tax Reform Do to Employee Benefits?

Tax practitioners and employers are struggling to digest this massive bill as quickly as possible but are up to their ears in this task. Not only must they move quickly to comply with the employee benefit provisions, but in addition, the new law will force them to undertake complete reappraisal of their current employee benefit packages.

The effects on benefits come from two directions: from the numerous provisions directly aimed at employee benefits and from the changes in the tax rates. The direct provisions, which took up 114 pages of the Act itself and 179 pages of the Conference Report, are intended to produce more comparable employee benefit coverage of rank-and-file employees and of highly compensated employees. The pension changes would increase the number of workers with a vested interest in their pensions by some 2 million workers in the first year alone. It would increase pension amounts for rank-and-file employees by limiting the coordination with Social Security benefits. And it would mandate broader and more comparable coverage of rank-and-file employees under pension, health, life insurance and other plans. Education assistance and group legal services will lose their tax

exclusion in 1988; employer-provided transportation benefits were allowed to expire.

If rank-and-file workers are the intended beneficiaries, higher-paid employees are the intended losers from the benefits provisions. Certainly the higher paid will enjoy lower tax rates. But they suffer potential losses in benefits. Some examples: restrictions on 401(k) salary reduction contributions; a new limit effective in 1989 of \$200,000 on the amount of compensation that can be taken into account under all qualified plans; a new excess benefit tax of 15 percent on most annual distributions over \$112,500; and sharply reduced maximum benefits paid to early retirees under defined benefit plans.

Changes in the welfare benefit areas, like health and life insurance, also aim for the same effects: an intended broadening of benefits because of tighter nondiscrimination rules that also reduce tax-favored benefits payable to the higher paid. Government staff have argued that reduced tax-favored benefits for the highly paid constitute more comparable coverage of rank and file and highly paid, when you view the benefits in terms of dollars, rather than as a percent of their compensation.

Effect of Tax Rates

Despite its good intentions, some unintended consequences of the new legislation may actually slow the future growth of benefit coverage and even result in less coverage in that sector of the economy—the small employer sector—where benefit coverage is the least available today. A top rate of 28 percent for the owners of a small business and 15 percent rate for 80 percent of taxpayers may make cash more attractive than benefits, which are also more difficult and more costly to administer under the new rules. The desirability of deferring compensation for nonretirement purposes under qualified plans is also called into question, because of new penalties on early withdrawals and the expectation that future tax rates may be higher than the new rates. Finally, because of the new restrictions on the higher paid, many employers will face the option of removing the higher paid from their general qualified benefit plans, which could result in a deterioration in benefits for rank-and-file employees. As more of their compensation is provided through nonqualified plans, the higher compensated may "lose their stake" in the general benefit plan. Obviously, whether nondiscrimination rules cause expanded and more comparable coverage of rank-and-file employees or reduce tax benefits for the highly paid will differ from employer to employer.

Employee benefits will remain an important piece of total compensation, but the changes in their tax effectiveness may

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The following remarks are adapted from an address to the Tax Foundation's 38th National Conference in December 1986. The opinions expressed are those of the author and do not necessarily reflect those of the Tax Foundation.

prompt a reevaluation of overall benefits and a return to the basic purposes employee benefits were intended to fulfill: the nontax purposes of promoting economic security and satisfying human resource needs.

Tax Committees Gain Upper Hand

If the late Senator Jacob Javits (R-NY), the father of ERISA, were still alive, he would tell you that it was the social policy that motivated him and not the tax policy. He and his colleagues approached the subject, as befits the Senate Labor Committee, from the angle of labor law and labor policy. Their goal was to fill a social need—the need for pensions and welfare benefit plans to promote economic security and protection of workers. With that social and labor policy in mind, tax preferences were seen as the instrument to encourage business to assume its share of the national responsibility of providing retirement income. That was the goal; tax preferences were the means of achieving that end. It was that kind of approach that led Senator Javits to start the ball rolling in 1967 that ended in ERISA's passage in 1974.

By the time of ERISA's tenth anniversary the tables had turned. By then, the "tax expenditure concept" was well-established. By that I mean, each dollar in revenue that could have been collected absent a tax preference began to be viewed as a cost to the government, as a government expenditure. In fact, the budget committees of Congress have viewed tax expenditures as entitlements like any other direct spending.

Despite serious flaws in the "tax expenditure" concept, particularly in the calculation and measurement of tax expenditures, the tax expenditure concept influenced congressional thinking.

Despite wild fluctuations in estimation, the size of employee benefit tax expenditures is very large—nearly \$60 billion in annual revenue losses from pension plans plus \$26 billion for health and for other benefits.

Gradually, the tax committees and the tax agencies of the Federal government had the most to say and do about what should be done about retirement income. For some, like Senator Javits, "This is the wrong end of the stick." But like it or not, that is what happened. And so years before the Tax Reform Act of 1986, tax committees had seized the initiative, often with bruised egos and hard feelings among the Labor Committee members who were losing the initiative.

TEFRA Marked the Turning Point

The Tax Equity and Fiscal Responsibility Act of 1982 in many ways marked the turning point. Here base broadening really began. It began because Federal budget deficits were huge and the Congressional Budget Office and others were predicting sharply rising interest rates unless additional revenues were raised. President Reagan stood then as he stands today, adamantly opposed to any tax rate increases. So base broadening was the only real alternative. And Congress took it.

For pensions and employee benefits TEFRA also marked the turning point in these ways:

- 1) Important legislative changes were thrust upon em-

ployers and the workplace without even a chance to influence the process.

- 2) Substantial cuts were made in tax benefits for qualified plans.
- 3) An era of roughly a half century of expansion of social programs and of employee benefits came to a close and retrenchment began.

Employee benefits became viewed by some leading senators and congressmen as "excessive," i.e., they were tax benefits enjoyed primarily by the higher paid, and therefore were an inadequate supplement to Social Security because too few individuals qualified for benefits.

Similar themes inspired the Social Security Amendments of 1983, the Deficit Reduction Act of 1984, and the Retirement Equity Act of 1984. They also spawned legislation to cap health tax benefits and to reform pension vesting integration and portability and coverage rules. And then along came tax reform on the fast track. The private sector looked upon this metamorphosis, or shift in public policy, with a mixture of bewilderment and alarm and betrayal.

As one private-sector speaker said at a conference on ERISA held by the Senate Aging Committee: "There was a time when the Federal government was clearly on the side of providing tax incentives for the development of private retirement programs in ways that advantaged workers in every part of our economy. It's no longer clear that that is the goal of the Federal government. We are hearing more and more about tax expenditures, we are hearing more and more about how this is an unjust way of providing retirement programs, while at the same time, the replacement rates of Social Security have dropped for the average worker. . . ."

So the provision of private-sector benefits, which was once viewed as a social partnership between government and the private sector, had begun to take on more of an adversarial relationship. Certainly there are important exceptions. Certain congressional staff have reached out. But generally an atmosphere of mistrust and suspicion and disrespect has taken hold. And Congress, which was critical of the status quo, was viewed by members of the private sector as being hostile rather than supportive of benefits in the workplace.

Why Did Tax Reform Rule the Workplace?

Treasury made the strongest statement here. Treasury's original tax reform proposal would have abolished many tax incentives for benefits on grounds that, "It is unfair that one taxpayer is excused from paying income tax on the value of a fringe benefit, while another who wants to enjoy the same good or service, but does not receive it as a fringe benefit, must purchase it with after-tax dollars." Benefits were viewed by Treasury as but one example of an overall tax system that is "complex, inequitable, and interferes with economic choices of households and businesses." Even here, however, the critics of inconsistency were themselves not fully consistent. The Treasury proposal made a major exception for retirement programs that are tax favored, saying, in effect, "This is a social purpose usefully and properly fulfilled through the Tax Code."

Echoes of the Treasury statement influenced the general tax reform justification—i.e., less intervention. Dan Rostenkowski, Chairman of the House Ways and Means Committee, argued we must stop using tax incentives to shape retirement policy. And he was by no means alone.

Yet when you look carefully at the final provisions of tax reform, you find very little in the employee benefits provisions that strikes you as government being less interventionist. On the contrary, it imposes the most elaborate and complex specifications that each qualified retirement, health or welfare benefit must comply with since ERISA was passed in 1974. These specifications are so detailed, so complex and so difficult to understand that for many plan sponsors, even for experienced practitioners, full compliance will be difficult, and in some cases well nigh impossible.

And what could not be done on the House or Senate floor did in fact take place behind the closed doors of the conference committee, where an agreement emerged that cut employee benefits by \$44 billion over 5 years—*more in cuts* than either the House or the Senate approved independently. In this case, the tax reform compromise didn't split the difference. Rather, it tended to take the more restrictive of the Senate or House provisions.

Forty-four billion dollars in revenue gains sounds large, and if you measure the revenue effects of the same provisions by using 1986-law tax rates instead of future, lower rates, the revenue gain would be much larger than \$44 billion.

Yet these same decisions about employee benefits reflect the thinking that benefits provided through the workplace are a more effective means of helping individuals than individual efforts by themselves. For example, over half of the benefit cuts come from individual retirement account (IRA) eligibility changes. That decision was revenue motivated—\$24 billion will be saved—but also a policy decision, that employer plans are less discriminatory from a tax benefit standpoint than IRAs, which were far more heavily used by higher-income taxpayers.

Because workplace-provided benefits keep their tax preferences, it is natural to expect more regulation of them. After all, nonintervention in economic decisions was chiefly the argument for *repeal* of tax breaks. Where tax preferences were *retained*, it is logical to expect continuous, even further regulation. What we got was *regulation* with a *vengeance*, a culmination of reforms discussed for years, many for a decade or more.

Here we see a different agenda coming into play, a long-standing agenda of pension and benefit reforms, intersecting or merging with the tax reform agenda. A reasonable argument for doing pension reforms in the tax bill can be made despite the fact that industry begged the Congress to disassociate the two issues of tax reform and pension reform. Interested congressional staff made employee benefits an issue of tax equity, an issue of where the tax benefits flow.

Bottom Line Policy

Practically and realistically, tax reform was the only vehicle likely to carry pension reform. Congress has followed a tendency in recent years to pass megabills dealing with

budget and tax issues. Sponsors of the Retirement Income Policy Act, from which many of the final provisions were drawn, saw this tax reform as the only chance to move the pension bill in 1986. They were able to attach it to the Senate Finance Committee version of H.R. 3838.

What was the policy? Its point of departure was, again, a tax expenditure analysis.

1. Tax benefits should not disproportionately go to higher paid (and hence tighter nondiscrimination rules were legislated).
2. Another policy objective is that programs should supplement Social Security—the purpose of the tax incentive is for that—not for short-term savings plans that are squandered before retirement. The various benefit provisions in tax reform could increase benefit payments at retirement by discouraging lump-sum payments, increasing coverage and benefit receipt, faster five-year vesting, integration, etc.
3. The third policy statement was that tax incentives for benefits should be limited and not unlimited. Within this concept of limits, the goal is to discourage *over*-accumulating as well as *under*accumulating. Provisions reflecting this goal are the 401(k) \$7,000 cap; the excess benefit cap; and the limit on includible compensation.

At the bottom line, Congress was saying to the workplace: "If you want to retain tax preferences for these programs, this is the price you have to pay." For the private sector, the price is administratively cumbersome; compliance is difficult, and costly.

But in the process, the other face of government policy was saying, "We're also going to make you less willing to pay that price." How? Through the lower tax rates of 15% and 28%.

Because of the lower rates, an option for noncompliance with the tough welfare benefit nondiscrimination rules is to remove the higher paid from the plan and have the higher paid pay the tax on the discriminatory (nonqualified) benefits.

Future growth of employee benefits will be far less than previously projected. The Social Security Administration has been projecting that tax-favored benefits would more than double as a percentage of pay between now and the middle of the next century. Actually benefit growth has already slowed down, and the new 15% and 28% rates are like pulling up the emergency brake.

Tax effectiveness can no longer be the chief selling point of a benefit plan. And, *looking ahead*, if you foresee higher tax rates, as many of us do, the wisdom of deferring compensation is called into question.

With tax effectiveness no longer the *chief selling point*, the decision to offer employee benefits will turn on different considerations. We will return to the original purposes of benefits: providing economic security and human resource needs.

So in this sense, the Federal government, through the lower tax rates, is after all intervening less in the *decision* to offer benefits. *But once* the decision to offer them is made, then the Federal intervention is direct and detailed to make sure the social policy purposes are being achieved. And this latter

type of Federal intervention in the workplace is likely to grow, rather than diminish in the future.

Other Mandates in the Workplace

Take a look at some other recent legislation:

- 1) Abolishing mandatory retirement.
- 2) Mandating that employers continue providing pension accruals and contributions for workers beyond age 65.
- 3) Proposing that employers contribute to state-wide risk pools to provide health coverage to the uninsured.
- 4) Proposing a mandate to provide unpaid parental leave.

The overall message is: Government wants to pay less for tax expenditures and wants to buy more for its money. Buying more for its money means thrusting greater social responsibility on employers. As Senator Javits would have said, "Business is going to be asked to shoulder its share of the social responsibility."

In the case of employer-provided retiree health benefits, we have seen Congress intervene to pass two different pieces of legislation directly aimed at a single company—LTV—and any others that may want to follow in the tracks of LTV Corporation.

During the 99th Congress, at least four bills passed that will affect employer-provided health care benefits; another seven were approved by committees of Congress; and another twenty did not make it out of committee. In all, some 30 odd bills in the 99th Congress.

The New Congress Will Continue Intervention

We have every indication that the 100th Congress, again limited by huge Federal deficits, will seek to fulfill social purposes in ways that don't carry a direct Federal price tag.

We note, for example, the statement Senator Edward M. Kennedy made last fall on his decision to assume the chairmanship of the Senate Labor and Human Resources Committee. He said he welcomed the opportunity to participate in "creating a new agenda for social progress in America." He went on to explain that he was "convinced that new approaches can work without increased spending. In a sense, the challenge on social issues in the next Congress," he continued, "will be the same far-reaching challenge met and mastered by the past Congress on *tax reform*—to develop *revenue-neutral* approaches that advance the great economic and social goals of our nation."

Now, one way of providing his goal of greater health coverage without more Federal spending is to mandate that employers provide more through the workplace. It therefore comes as no surprise to learn that Senator Kennedy intends to reintroduce the Access to Health Care Act that would have required employers to extend health insurance coverage to laid-off workers for four months and forced states to set up payment systems for uncompensated health care and insurance pools for individuals at high risk. Senator Kennedy's staff have now reportedly been saying that the new legislation may require that all U.S. employers provide at least a minimum level of health insurance coverage to all workers. That could be done by making health benefits part of the minimum wage.

Senator Kennedy is by no means alone in viewing mandating as a way of getting more out of the workplace. Mandating benefits through the workplace is also not something unique to the Federal government. Members of Congress have watched the states impose more and more rules. More than half of the states, for example, mandate some form of specific health provision by employers, although the reach of these state mandates does not extend to the growing number of large employers who self-fund their health insurance plans.

Not only is there precedent for Federal mandates coming from the states, but when Health and Human Services Secretary Otis Bowen released on November 20 some recommendations to improve catastrophic protection for the general population, one of his recommendations was that states mandate the offer of catastrophic protection in employee-related health insurance. In effect, the Federal government would be urging and relying on state mandates.

Tension Between Congress and the Private Sector

We have talked about "Congress and the Workplace" and at times the adversarial stance that people in the private sector perceive about the way Congress acts on benefit issues. In the long run, I don't believe that attitude really can endure, because it is antithetical to a representative political system such as ours.

It happens in the short run, in part, because these benefit issues are so technical and so complex that individual members of Congress don't understand them and don't in fact decide them. More than any other issue, benefit decisions are delegated to staff. That delegation is unwittingly facilitated by the private sector, because often the business leaders do not escalate these issues to the level that *demands* a member of Congress' attention. For example, during tax reform, business had so many other overriding tax issues, that most had "bigger fish to fry." Few wanted to expend all their political capital on an issue that does not directly affect the corporate bottom line.

The trend that we foresee of greater congressional intervention and mandating of social responsibility is going to affect a firm's bottom line, its profitability. For example, if a tax were levied upon firms to finance risk pools for the uninsured, in effect, business would be taxed to provide benefits to nonemployees. This may cause corporate leadership to escalate the priority of some of the benefit issues, particularly if the Tax Code remains stable for awhile and competing tax issues do not come to the fore. But if business does not make benefits a priority, Congress will make the decisions for them.

Finally, the private sector can influence Congress through its own good example. Often, Congress will take a practice developed in the private sector but practiced by a minority of firms and make that the norm. For example, in the employee benefits area, one could argue that congressional mandating of faster vesting and revised integration rules did not come completely out of nowhere. By shifting to defined contribution plans increasingly, the American workplace implicitly recognized the need for faster vesting. If the private sector cannot stop congressional intervention, it can nonetheless do much more to shape its long-term course.

Tax Bill's Effects on Economy/States Weighed at Conf.

No detailed and definitive assessment of the economic fallout of the Tax Reform Act of 1986 (TRA-86) is possible, Norman B. Ture, president of IRET and former Undersecretary of the Treasury for Tax and Economic Affairs, observed to the morning session of Tax Foundation's 38th National Conference. The Bill is so large and varied, he said, and so is the economy of the United States, that precise analysis is impossible.

A Major Revision

Calling TRA-86 "surely among the very biggest tax events in our nation's fiscal history," Ture faulted the policy-makers who developed the legislation for focusing little attention on how the Act would affect the U.S. economy. The reason, he contended, was that "the process was driven by an initial decision about some specified tax changes, principally rate reductions, constrained by the dicta of revenue neutrality and no new revenue sources, fueled by efforts to rationalize these changes in terms of policy objectives—simplicity, equity, and economic neutrality—the substantive content of which was never spelled out."

- *Simplification.* "In a nutshell, the relevant measure of tax simplification is the extent to which it results in shrinking the Internal Revenue Service," Ture said, contending that, under TRA-86, "the tax law has been made substantially more complex."

- *Equity.* "It is difficult to discern in TRA-86 anything that represents a significant equity advance," he maintained. "There are, on the contrary, numerous changes in the Act that make the income tax more unfair."

- *Economic Neutrality.* Achieving neutrality in tax policy, Ture explained, "requires first identifying the relative price effects of the tax or of specific tax provisions; you're not likely to hit a target you don't see. No such effort was apparent as TRA-86 went from drawing board to final enactment."

Ture predicted:

- a gradual slowdown in addition to the stocks of capital in the industrial sectors, possibly accompanied by relocation of expansion from domestic to foreign sites;

(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation

"A Backdoor Tax Hike"

It is a commonplace of constitutional law that no U.S. Congress can bind another. Before the 100th Congress even left the starting blocks, this became apparent once more, as part of the congressional leadership floated the idea of reneging on the rate cuts written into the Tax Reform Act of 1986 (TRA-86) by the 99th Congress.

Under TRA-86 the top individual rate is scheduled to drop to 38.5 percent in 1987 and 28 percent in 1988. Congress is manifestly incapable of reaching the 1988 Gramm-Rudman-Hollings deficit reduction target of \$108 billion. So part of the leadership wants to lock in the 1987 top rate "temporarily" to reduce the deficit.

Freezing the top rate at 1987 levels, we are told, affects only "the wealthiest people of our country." Apparently, \$54,000 of taxable income now ranks an unmarried American worker among the "wealthiest." In fact, if the 35% rate were kept, too, this group would include those with incomes as low as \$27,000. To make a real dent in the deficit, Congress would have to extend both the 38.5% and the 35% rates. There is also a lot of vagueness about how long this "moratorium" will last.

There are many sound reasons for opposing this fiscal shell game, no matter how many taxpayers at whatever income levels are affected:

- TRA-86 cancelled an enormous number of tax preferences in the name of simplification and in exchange for rate reductions. Freezing the rates at 1987 levels would be a *de facto* tax hike that betrays that compact.

- Withholding the rate cuts is the crassest kind of bait and switch tactic. It would seriously erode what little credibility the U.S. Congress has.

- TRA-86 survived the legislative grist mill largely because lower rates were perceived as compensating for the loss of tax preferences, making the bill revenue neutral. Locking in the '87 rates will destroy any pretensions TRA-86 may have to neutrality.

- Tax uncertainty has been a millstone around the neck of the U.S. economy for a decade. Such a quick about-face on a bill that was supposed to see us at least through the end of this decade will only aggravate uncertainty. If the moratorium is in fact a moratorium, how long will it last? What will be the final rate? Who will believe Congress, no matter what answer it gives?

The U.S. Congress has no monopoly on bad ideas. However, proposing to hold back the rate cuts of what Congress has been vaunting as the greatest piece of tax reform legislation of this generation almost before the ink was dry on the President's signature on TRA-86 has to rank as a world-class blunder.

POLICE PROTECTION?



TAX FOUNDATION

ART WOOD

(1988 BUDGET, from page 2)

raise its revenue estimates at the same time that it has lowered its forecast for economic growth.

If the budget's long-range forecast is to be believed, the nation will go through a full decade without a recession. Indeed, the growth assumed for the end of the 1980s and beyond is far above recent experience.

Interest rates are another vulnerable piece of the economic puzzle. The White House is banking on a continuing decline in both short- and long-term rates. In fact, it anticipates that "real" interest rates (the difference between inflation and nominal interest rates) will drop from 7 percent in 1985 to only 3 percent in 1988. With the Treasury heavily dependent on Japanese and other foreign investors to market its obligations, a lot of things can go awry and spur a renewed spiral in interest rates.

Other Revenue Questions

Higher deficits also can be caused by revenue shortfalls that are due to estimation errors rather than to economic conditions. The new budget is especially prone to these errors because tax reform has made revenue estimates much more uncertain than is usually the case.

The table presented below displays the long-term trend in revenues. Note that the shift in the income tax burden from individuals to corporations will lead to a projected rise in corporate income taxes from 8.2 percent of total receipts in 1986 to an estimated 12.8 percent in fiscal 1988. This is an exceptionally large swing in a short period of time.

General revenues now cover only about 80 percent of general outlays. This percentage may well decline further as social insurance funds become even more prominent in the total Federal budget. The result could be an even tighter squeeze on government operations than indicated by the overall figures.

(DOMENICI, from page 1)

that he characterized as old, outmoded, irrelevant and lacking in cost-benefits. While not ruling out the need for additional money on the revenue side, Dominici said, "It's clearly achievable with some sort of user fees and the like."

Calling the Gramm-Rudman-Hollings deficit reduction from fiscal 1986-1987 "the most significant deficit reduction in the history of the Republic any way you look at it," Dominici told the Foundation's Trustees and other leading business executives at the Dinner, **"I urge that you join with anyone who will make it tough on Congress to wipe out Gramm-Rudman-Hollings . . . join with those who would put the teeth back in."**

Foundation Chairman Hans W. Wanders of The Wachovia Corporation, who presented the Distinguished Public Service Award to the Senator, pledged, "I can promise you that the resources of the Tax Foundation will be available to keep the spotlight on the real issues, to make sure that the numbers used in the debate are accurate and honest, and in cutting through the linguistic density that public officials love to use to obscure things they'd rather not have see the light of day."

In the 20 months until the 1988 fiscal year goes into the history books, a lot of things can go wrong to unravel the Administration's budgetary optimism. The economy might falter, interest rates might start to climb, Congress might legislate spending increases rather than cutbacks, revenue might come in lower than expected. **Not everything that can go wrong has to for the deficit to soar high above the GRH target level. A fair reading of the 1988 budget leads to the following warning: The battle of the deficit is not over. The outlook is more favorable than it was last year when the deficit exceeded \$220 billion. But it wasn't hard to get to \$200 billion a year deficits; it won't be hard to repeat the same mistakes.**

('86 TAX BILL, from page 3)

- a shift from production for export to production for the domestic market; and
- erosion of the tax-exempt municipal bond market and real estate development.

Keep Rate Cuts on Track

"What saves [TRA-86] from being an economic catastrophe," Ture concluded, "is its rate reductions. He warned that any move to extend either 1986 or 1987 rates, rather than move the rate-cut timetable forward on schedule "would impose a serious threat to the economy."

Impact on the States

Anticipated effects of TRA-86 on state/local governments came next on the conference agenda, covered by Professor James A. Papke of Purdue University. He anticipated that "1987 will probably go down as a record year in terms of action at the subnational level."

He pointed out that, despite reports that state/local governments are "running a small surplus," conditions vary "substantially" from state to state, with oil patch states recording negative balances and smokestack and Eastern states "enjoying substantial positive balances."

"There will be no rush to adjust state-local sales taxes," Papke said, "although the repeal of the deductibility of this levy may lead states heavily dependent on sales taxes "to look carefully at possible increases."

"The most significant effect" on state and local governments "will be to increase competition among the states, primarily for businesses, but also indirectly for individuals as well. . . . There will be increasing emphasis on creating distortions in tax structures in order to attract business."

Frederic W. Hickman, partner in the Chicago law firm of Hopkins and Sutter, also participated in the morning session on "The Tax Reform Act of 1986." Most of his presentation is reproduced in the November/December 1986 issue of *Federal Tax Policy Memo*. Copies are available from the Tax Foundation.

The afternoon session addressed the issue of "Congress and the Workplace." Speakers were Frank B. McArdle, director, Education and Communication of the Employee Benefit Research Institute, whose presentation appears as this month's *Federal Tax Policy Memo* and A.L. Singleton, minority chief of staff, Ways and Means Committee, U.S. House of Representatives.

Budget Receipts

	Amount (in billions of dollars)				% Budget Receipts			
	1968	1978	1986	1988*	1968	1978	1986	1988*
Individual Income Taxes . . .	\$69	\$181	\$349	\$393	44.9%	45.3%	45.4%	42.9%
Corporate Income Taxes . . .	29	60	63	117	18.7	15.0	8.2	12.8
Social Insurance Taxes	34	121	284	333	22.2	30.3	36.4	36.4
Excise Taxes	14	18	33	33	9.2	4.6	4.3	3.6

Source: Budget of the U.S. Government, FY1988 and earlier years.

TAX·FEATURES

U.S. Family's Federal Tax Bill Will Hit \$7,551 for Fiscal '87

There Never Was a Budget That Couldn't Be Cut, CBO Reconfirms

In the waning years of the Reagan presidency, there is talk in Washington of the tax increases that will be necessary to pay for Federal programs and shrink the budget deficit. It is fashionable these days to say that spending has been cut so much in the 1980s that there is no room to prune it any more. Another favorite argument is that the discretionary part of the budget is so small that cuts would hardly dent the deficit.

The arrival of the first trillion dollar budget should make one wary of claims that Federal spending is so drum tight that no new savings can be found. The old budgeter's refrain, "I never saw a budget that couldn't be cut," applies to the current predicament. A recent report by the Congressional Budget Office (CBO) convincingly demonstrates that sizable cuts can be made in a prudent and responsible manner. The CBO report identifies almost 70 major options for reducing Federal expenditures. According to CBO, most of the options have been proposed—but not adopted—in the past; none, however, is "so extreme as to be implausible."

Because adoption of one option might preclude implementation of another, it is not possible to compute the total savings that might be realized. Nevertheless, some useful conclusions can be drawn concerning the opportunity for significant deficit reduction in the years ahead.

- In the short run—this year and next—the Gramm-Rudman-Hollings deficit targets cannot be met by spending cuts alone. Program cut-backs often produce delayed outlay reductions which show up in later budgets. For example, a slowdown in defense procurement would yield modest outlay savings in the first year or two, but much larger amounts in the outyears.
- For this reason, significant deficit reduction can be best achieved in a multiyear framework. Over a five-year period, the CBO options could lower Federal outlays by hundreds of billions of dollars, even after adjustments were made for mutually exclusive proposals.
- The Gramm-Rudman-Hollings target of a balanced budget in the 1991 fiscal year can be met

(Continued on page 3)

A moderate-income family—one worker earning \$29,000 solely from wages with a spouse and two dependent children—faces a tax bill of \$7,551 for fiscal year 1987.

That covers the family's share of direct and indirect Federal taxes. Add to this their \$1,596 share of the Federal deficit, and the family pays \$9,147 to support the estimated \$1.02 trillion Uncle Sam plans to spend in fiscal year 1987.

Economists at the Tax Foundation use this prototypical family as a way of showing where the average American household's tax dollars go. Assuming that \$7,551 tax bill is allocated to cover the family's whole share of Federal spending, the following spending items stand out.

"Income security" costs the most—\$332.8 billion. This comprises Social Security and Federal employee retirement and disability, unemployment insurance, housing assistance, and other programs. The Federal

(Continued on page 4)

THIS ISSUE:

PAGE 1:
Worker's Tax \$ Federal Budget

PAGE 2:
State-Local Taxes

PAGE 3:
Meeting Targets

INSERT:
Cost of Capital

How the Federal Government Will Spend A Worker's Tax Dollars in Fiscal 1987^a

Function	Worker's share		Total spending (millions)
	Amount	Percent of total	
Income security ^b	\$2,387	31.61	\$ 332,770
National defense	2,024	26.81	282,246
Net interest	986	13.06	137,461
Health ^c	798	10.57	111,279
Agriculture	223	2.95	31,084
Education, training, employment, and social services	214	2.83	29,808
Transportation	194	2.57	27,017
Veterans' benefits and services	191	2.53	26,679
International affairs	105	1.39	14,607
Natural resources and environment	100	1.32	13,857
General science, space, and technology	68	.90	9,523
Commerce and housing credit	66	.88	9,300
Administration of justice	60	.79	8,293
General government	49	.65	6,840
Community and regional development	44	.59	6,167
Energy	27	.36	3,787
General purpose fiscal assistance	14	.18	1,944
Total ^d	\$7,551	100.00	\$1,015,572
Exhibit:			
Payments for individuals	3,338	44.21	465,338

^a In this example, the worker is the sole source of support for a spouse and two dependent children, and earns \$29,000 per year.

^b Includes social security, Federal employee retirement, unemployment compensation, housing assistance, food and nutrition assistance; excludes veterans' income security.

^c Includes Medicare, Medicaid, and others; excludes veterans' hospital and medical care.

^d After deducting \$37.091 million in undistributed offsetting receipts not classified by function.

Source: Tax Foundation computations, based on Federal Budget presented January 5, 1987 (Office of Management and Budget) and tax laws from Treasury Department.

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FEDERAL TAX POLICY MEMO

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MARCH 1987

Increase in the Cost of Capital: Quantitative and Other Results of the Tax Reform Act of 1986

By Ernest S. Christian, Jr., and David G. Raboy

The two dominant ingredients of the Tax Reform Act of 1986 were a substantial reduction in marginal tax rates and a drastic reduction in capital cost recovery through repeal of the ITC and the cutback of ACRS depreciation for new investment in capital equipment in the United States. If the Treasury's original "tax reform" hypothesis turns out to be true, the gain to the economy from an assertedly more efficient allocation of resources will significantly outweigh the loss to the economy from increasing the cost of new investment in capital equipment. If that hypothesis proves false, the 1986 Act should cause *both* a lesser amount of new investment in capital equipment *and* a lesser overall level of output than would otherwise be expected to occur.

The one most critical and quantitatively answerable question now is: *by how much did the 1986 Act actually increase the cost of capital for new investment in productive capital equipment in the United States?* By any measure, the 1986 Act enormously increased the cost of capital for new investment in equipment.¹ When calculated using Treasury's methodology, the range of increase for 22 illustrative ADR classes of equipment was from 49.5 to 77.8 percent.² It is not obvious how efficiency gains could be projected to offset the effects of an increase of that magnitude in the cost of capital for *new* investment in equipment. Furthermore, the 1986 Act also reduced by about 25 percent the effective tax rate on future income from *old* investment in equipment.³ This large bias against new investment in favor of old is part of a pattern throughout the 1986 Act.

¹ Throughout, the references herein are to the cost of capital for equipment purchased by corporations.

² Increases of these general orders of magnitude are confirmed by the recently issued 1987 Economic Report of the President which indicates that under the "new view" of the cost of capital, on a weighted average basis for all industries, the 1986 Act increased the cost of capital for equipment by 62.2 percent.

³ When fully phased in, the 1986 Act will have reduced by 25 percent the marginal corporate tax rate on income derived in the future from investments that were allowed the ITC and full ACRS depreciation under prior law.

ABOUT THE AUTHORS

Messrs. Christian and Raboy are, respectively, the senior tax partner and the chief economic consultant of Patton, Boggs & Blow, Washington, D.C. Mr. Christian is a former Deputy Assistant Secretary of the Treasury (Tax Policy). Dr. Raboy is the former Legislative Director for Senator William Roth. The opinions expressed are those of the authors and do not necessarily reflect those of the Tax Foundation.

Background: Failure to Focus on the Critical Issue

From the outset of the tax reform debate, Treasury steadfastly insisted that the cost of capital should be measured by taking into account the projected tax rate reductions for both individuals and corporations as well as the changes in capital cost recovery. The problem is not with Treasury's basic methodology which is reasonable provided the calculations are properly made and presented. Rather, the problem is that the most meaningful results of Treasury's methodology seem not to have been presented to the tax-writing committees during their deliberations on the 1986 Act.

In the Senate, in response to oft-repeated and genuine concerns by many Members of Congress about tax reform's potential adverse effects on international competitiveness, the Treasury did supply estimates of the aggregate change in the cost of capital for all corporate investment combined—including land and inventories, although neither was particularly related to the concerns about international competitiveness or adversely affected by the repeal of the ITC and the cutback of ACRS depreciation. The huge increase in the cost of capital for equipment was never separately stated. The real concerns of the Congress about capital equipment and international competitiveness appear to have been lost in the shuffle. Consequently, it appears that the Congress never really came to grips with the issue that may most significantly alter trade and international capital flows as well as the overall long-term growth potential of the economy.

Measuring the Cost of Capital

The 1986 Act radically changed the two major elements of business taxation—tax rates and the capital cost recovery and related provisions. In order to take account of both, the model used here defines the "cost of capital" as the pre-tax rate of return needed to produce a given after-tax, real rate of return for the investment in question. The model makes the standard assumption that a 4 percent real after-tax "hurdle" rate of return is necessary to justify any investment being made. The "tax wedge" is the excess of the cost of capital over the hurdle rate. An increase (or decrease) in that tax wedge increases (or decreases) the cost of capital. Like the Treasury model, the model used here necessarily defines the pattern of income the asset is expected to produce over time. A 4 percent inflation rate is assumed. Corporations are assumed to be one-third financed by debt. All mathematical expressions and data were chosen to replicate as closely as possible Treasury methodology as found in public documents. (See Appendix.)

The calculations reflect repeal of the ITC, the cutback in ACRS depreciation, changes in corporate tax rates, changes

in ordinary income and capital gains tax rates for individuals, state and local income taxes at both the corporate and individual level, and local property taxes.

Increase in Cost of Capital Equipment Capital

The cost of capital for new investment in equipment was calculated under pre-1986 Act law and under fully phased-in 1986 Act law. The table on this page shows the change in the cost of capital for equipment in each of 22 industries defined by ADR class.⁴ Relative to pre-1986 Act law, the range of increase was from 49.5 percent to 77.8 percent. The increase exceeded 70 percent in three classes, 60 percent in seventeen classes, and 50 percent in twenty-one classes.

The chart on page 3 shows the cost of capital for new investment in equipment in five industries *before* and *after* the 1986 Act.

Understated Capital Cost Increases

Astoundingly large as they are, these increases in the cost of capital for new investment in equipment may actually be understated. First, if the same calculations were made for the period of the 1986 Act transition *after* the ITC was repealed and the other cost recovery changes are effective, but *before* the tax rate reduction is fully in effect, the increase in the cost of capital would be even greater. Second, these calculations do not reflect the new "capitalization" provisions in the 1986 Act which have the effect of further deferring depreciation deductions and increasing the cost of capital for equipment. Third, while not quantifiable in these mathematical comparisons, the preference in the 1986 Act for old investment should weigh in the balance against new investment somewhat the same as a further increase in its cost.

Lower Productivity Gains

Absent future tax changes to correct the imbalance, the cost of capital for new investment in equipment will always in the future be higher than before the 1986 Act was enacted. Accordingly, there should be a permanently lower level of net new investment in equipment in the United States. The rate of growth in overall new investment in equipment in the United States should be smaller because under the 1986 Act fewer new investments will produce the requisite after-tax

**Cost of Capital For Twenty-Two
Illustrative ADR Classes of Equipment**

Industry Classification by Activity (Product)	ADR Class Number	Old Law Cost of Capital	New Law Cost of Capital	% Change in Cost of Capital
Mining	10	0.0435	0.0739	70.02
Oil Production	13.2	0.0435	0.0738	69.80
Construction	15.1	0.0438	0.0699	59.44
Grain	20.1	0.0427	0.0758	77.53
Manufacturing				
Tobacco	21	0.0429	0.0705	64.52
Manufacturing				
Textiles (woven fabric)	22.2	0.0423	0.0674	59.33
Wood Products	24.4	0.0430	0.0713	65.68
Pulp and Paper	26.1	0.0423	0.0674	59.33
Printing	27	0.0427	0.0697	63.12
Chemicals	28	0.0424	0.0634	49.55
Petroleum Refining	13.3	0.0427	0.0759	77.84
Rubber Products	30.1	0.0424	0.0679	60.05
Leather Products	31	0.0433	0.0728	68.21
Glass Products	32.1	0.0428	0.0698	63.35
Stone/Clay	32.3	0.0428	0.0698	63.35
Products				
Ferrous Metals	33.1	0.0425	0.0742	74.70
Non-Ferrous	33.2	0.0425	0.0683	60.76
Metals				
Fabricated Metals	34	0.0429	0.0705	64.52
Machinery	35	0.0429	0.0704	64.28
Electronics	36.2	0.0427	0.0649	51.86
Products				
Motor Vehicles	37.11	0.0425	0.0684	61.00
Aerospace	37.2	0.0431	0.0718	66.60

hurdle rate of return. Compared to the past, many investments that were profitable under prior law will no longer be made. As a consequence, there should be lower productivity gains than would otherwise be the case and, all else being equal, an erosion of U.S. competitiveness in the manufacturing sector. Taken in isolation, there should also be a deterioration in the terms of trade for manufactured goods due to the new relative cost disadvantage of the productive processes in the United States.

Potentially Offsetting Efficiency Gains

Because the 1986 Act increased the cost of capital for equipment by such a large amount, the expected adverse impacts on new investment and productivity growth should also be substantial. Thus, the question recurs on the issue of potentially offsetting efficiency gains.

Congress relied greatly on Treasury's assertion that prior law was so grossly *nonneutral* across industry lines and even among assets in the same industry as to cause severe "compositional inefficiencies" in the mix of assets being used. In effect, the Treasury contended that the ITC and ACRS depreciation had altered the tax treatment of investments in equipment to the point that inefficient investment choices were being made. The Treasury then hypothesized that by correcting these nonneutralities tax reform would cause a more efficient mix of capital equipment and more efficient choices as between capital equipment and other investment opportunities. Presumably, these compositional efficiency gains were expected to produce an overall level of output equal to or greater than under prior law.

Analysis does not support such an aggressively optimistic view. The table above indicates that within the capital equip-

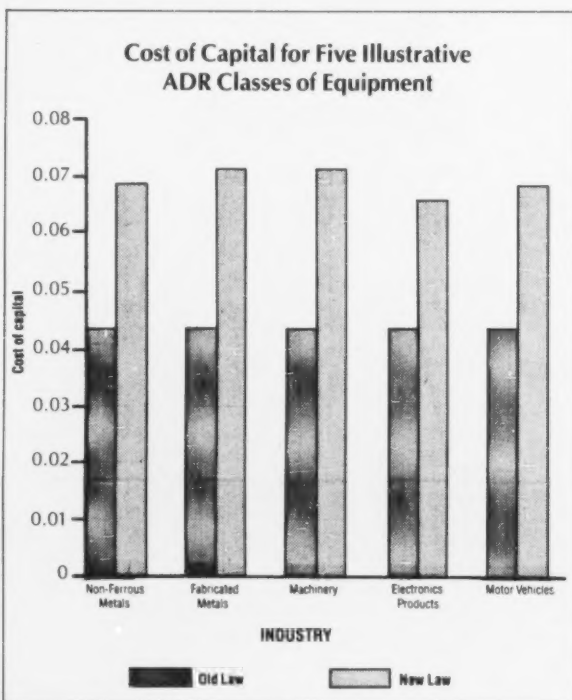
⁴ There are roughly 50 ADR classes that represent industry activities or subactivities, and an additional number of asset-specific ADR classifications. The 22 broad industry-wide ADR classes in the table were chosen because the data set on the value of tax depreciation and the data set on the rate of capacity decay correspond (i.e., in the case of each industry all the equipment that was five-year ACRS property under prior law is contained in a single ADR class for that industry and each industry is assigned a single aggregate rate of capacity decay based on a weighted average of specific assets). The data set on capacity decay includes other industries, but in those cases the industry's equipment is in more than one ADR class and under the 1986 Act the value of tax depreciation varies from one class to another. If the relative amounts of each additional industry's investment in each class were determined, it would be possible to calculate the cost of capital under the 1986 Act for those industries as well. The overall results would not be substantially different from the results shown in the table for 22 industries.

ment category, prior law was significantly more neutral from one ADR class to another than the 1986 Act. The New Law column shows substantial variations in the cost of capital from one ADR class to another, whereas the Old Law column shows very little variation among those same broad industry classes.⁵ It is true that under prior law there was some substantial variation in the cost of capital for specific assets *within* a broad industry class, but the mix of assets utilized by any industry is dictated primarily by the production process (e.g., a drill press cannot do the work of a basic oxygen furnace). Therefore, the potential under prior law for tax-induced substitutions of assets that result in inefficiency was very limited. Moreover, to the extent that there was under prior law any significant intra-industry nonneutrality in the treatment of capital equipment, it is clear that the 1986 Act did not cure this defect. The reduced version of ACRS in the 1986 Act as well as the earlier CCRS and RCRS proposals by the Treasury are all based on ADR classes that contain the same mix of assets as before.

Looking beyond the capital equipment category, little encouragement is to be found in the broader contention by the

Treasury that substantial *net* gains are to be derived from correcting the asserted nonneutrality of prior law as between capital equipment and other investment choices. Let us face it, the underlying premise would have to be that prior law taxed all capital equipment, or a major portion of it, too little and that there was too much investment in capital equipment, or in certain kinds, compared to investment in land, structures and inventories. Further, the 1986 Act undertook to cure this asserted defect by substantially increasing taxes on capital equipment instead of by merely decreasing taxes on other investment choices thought to be taxed too heavily. When a *gain* from greater compositional efficiency is sought to be achieved in that manner, there is an associated *loss* to the economy from the intertemporal inefficiency which results when firms are caused not to make investments in capital equipment that would be productive, that would make economic sense and that would be made but for the substantial tax increase imposed by the 1986 Act.

Assuredly, the 1986 Act did reduce the marginal tax rate for corporations, but the 1986 Act also imposed on corporations a large overall tax increase as the *net* result of rate reduction and diminished capital cost recovery. It goes without saying that corporations with relatively high ratios of new capital equipment investment to profit will bear most of the substantially increased tax burden. If corporation A has a relatively low ratio of new capital equipment investment to profit, the reduced marginal tax rate will be the dominant factor and corporation A should have a tax decrease relative to prior law. If, on the other hand, corporation B has a relatively high ratio of new capital equipment investment to profit, the diminished capital cost recovery will be the dominant factor and corporation B should have a tax increase. Broadly speaking, in order to maximize its after-tax profit corporation B should seek to be more like corporation A. That transformation might to some extent be achieved by belt-tightening, working harder and other laudable efficiencies to increase the level of its pre-tax profit relative to its pre-established level of new capital equipment investment. Most probably, however, corporation B's response primarily will be to reduce its level of new capital equipment investment. Unfortunately, seeking to maximize profit in this manner does not necessarily maximize output or result in an overall greater "welfare benefit" to the economy at large.



⁵ That result obtains because the ITC and five-year ACRS depreciation applied uniformly to all these classes and the data set on industry-wide capacity decay indicates that the aggregate mix of assets in *all* industries declines in value over time at fairly close to the same rate. Thus, the basic comparison between the Old Law and the New Law columns would not be substantially changed if additional broad ADR classes were included. Although "asset-specific" costs of capital would vary greatly under both prior law and the 1986 Act, industry-wide comparisons are the most relevant to the neutrality issue.

Implications for International Competitiveness

To state the obvious, the ability of the United States to compete in international markets must be based on "comparative advantage" as the economy develops and improves technologies, and then produces products through a combination of raw resources and the services of capital and labor. The United States probably still has some comparative advantage in technology although that is now severely challenged. While the United States once enjoyed some comparative advantage in raw resources, resources are now generally competitive throughout most of the world. The United States never in modern times enjoyed a comparative advantage in the cost of labor and should not expect to.

With the 1986 Act, we now seem to have relinquished our comparative advantage in the cost of capital, also.

Appendix

The methodology and data used in these calculations were chosen to recreate, to the extent that information is publicly available, Treasury's technique in calculating the cost of capital.

The Model

The actual equations are identical to those found in the following papers:

1. "The Indexation of Interest, Depreciation and Capital Gains: A Model of Investment Incentives" by Don Fullerton, American Enterprise Institute, AEI occasional papers; Working Paper #5.
2. "Differential Effects of the Accelerated Cost Recovery System on Investment: A Survey, with Implications for Understanding Effects on High Technology Investment" by Don Fullerton and Andrew Lyon, unpublished.
3. "The Impact of Fundamental Tax Reform on the Allocation of Resources" by Don Fullerton and Yolanda Henderson, NBER Working Paper #1904.
4. "A Disaggregate Equilibrium Model of the Tax Distortions among Assets, Sectors, and Industries" by Don Fullerton and Yolanda Henderson, NBER Working Paper #1905.

In these papers, the cost of capital comes from the firm's equilibrium condition:

$$(1-k)q = \int_0^{\infty} (1-u)(c-wq)e^{(\pi-\delta)t} e^{-i(1-u)t} dt + uaz \quad (1)$$

where

- q = asset price
- u = the corporate tax rate
- k = the rate of investment tax credit
- z = the present value of depreciation deductions per dollar of investment
- a = the amount of basis adjustment associated with the ITC
- w = the rate of local property tax
- π = the inflation rate
- δ = the rate of capacity decay
- c = the gross rate of income generation
- i = the nominal discount rate

The cost of capital, rho, can be derived from equation (1):

$$\text{rho} = c/q - \delta = \frac{i(1-u) - \pi + \delta}{1-u} (1-k-uaz) + w - \delta \quad (2)$$

Individual taxes enter equation (2) through the formulation of the firm's discount rate. This is determined from an expression for the average real net of tax return to capital at the individual level, s:

$$s = d_d[i(1-\tau_d)] + d_{re}[i(1-u)(1-\tau_{re})] + d_{ns}[i(1-u)(1-\tau_{ns})] - \pi \quad (3)$$

where

- d_d = the share of investment funded by debt
- d_{re} = the share financed by retained earnings
- d_{ns} = the share funded by new shares paying dividends
- τ_d = the tax rate on debt
- τ_{re} = the effective tax on retained earnings at the individual level
- τ_{ns} = the tax rate on dividends

s is set by assumption and i is solved for in equation (3) and inserted into equation (2) to determine the cost of capital.

The Data

The assumed hurdle real after-tax rate of return to individuals, s, (an economy-wide average) is 4 percent. The inflation rate is also set at 4 percent.

Tax rates are based on economy-wide averages and come from various papers by Yolanda Henderson and Don Fullerton:

Data on financial structure also comes from Fullerton. It is assumed that 33.7 percent of investment is financed by debt, 61.4 percent by retained earnings, and 4.9 percent by new shares paying dividends. Notice that the result of this assumption is that the dividend tax becomes relatively unimportant. Empirically, then, the results will tend towards the "new view" of the cost of capital where

Combined Federal, State and Local Marginal Tax Rates

	Old Law	New Law
Corporate	49.5%	38.3%
Individual		
Interest received	23.1%	19.5%
Dividends Received	29.2	23.5
Capital Gains	5.2	9.1
Property Tax		.768%

dividend taxes are held to be not important vis-a-vis taxes on capital gains. The new view, however, is not an explicit assumption of this paper.

Calculation of the present values for depreciation is based on explicit discreet depreciation deductions. Fullerton uses a continuous time representation. There is some debate as to the proper discount rate for the first-year discount. Some researchers (Hulten) discount fully. Fullerton's continuous model allows partial discounting. Some researchers do not discount the first year at all. A full discount is used here. As long as consistency is maintained, the absolute results will be slightly affected but the relative results will not be affected.

The cost of capital calculation is performed for 22 industries. These are industries where one ADR classification covers all equipment (five year property under prior law) in the industry and there is a corresponding single value for capacity decay from the data set employed. As such each industry has one tax depreciation treatment and one capacity decay rate. Other industries could easily be modeled by calculating the proportion of assets in each new depreciation class and then constructing a weighted average for the present value of depreciation. The results would not be qualitatively different from the results reported here. Consider, for instance, the communications industry. Much of its property would be in ADR classes .12 and .13 as well as 48.11-48.45. Much of the property would be in the 5-, 7-, and 10-year classes under current law and would have been five-year property under old law. The estimated capacity decay rate is 12.2 percent per year, similar to the paper and textile industries. It is to be expected that changes in the cost of capital from old to new law would be qualitatively the same as with other industries.

Industry-wide rates of capacity decay, used to define patterns of income generation, come from calculations by Jane Gravelle at the Congressional Research Service. In our calculations we employ Gravelle's average decay rates and calculate the cost of capital for each industry. Fullerton/Henderson, on the other hand, calculate the cost of capital for each asset in each industry using asset specific decay rates (from Hulten/Wykoff) and then average these asset costs of capital for each industry. Since Gravelle uses the same asset specific decay rates in calculating her average rates, as long as the same weights are used, the two techniques are algebraically identical. To see this consider the following:

Consider industry i which has j assets. Under the Fullerton/Henderson formulation the cost of capital is:

$$\text{rho}_i = \sum_j \theta_j \left\{ \frac{i(1-u) + \delta_j - \pi}{1-u} (1-k_j - uaz_j) + w_j - \delta_j \right\} \quad (4)$$

where θ_j are the weights assigned to each asset type.

By definition i, u, π , and a are the same for all assets. Also, Fullerton/Henderson assume one rate of property tax, w, for all equipment. Under old law, for the industries represented here, equipment was in the five-year category and all investment qualified for an ITC. Under new law, which is based on ADR lives, all equipment in the industries represented is in the same category. Accordingly, equation (4) can be written as:

$$\text{rho}_i = \frac{i(1-u) + \sum_j \theta_j \delta_j - \pi}{1-u} (1-k - uaz) + w - \sum_j \theta_j \delta_j \quad (5)$$

But this is exactly the formula employing an industry-wide capacity decay rate in the cost of capital formula.

The only difference, thus, between the Fullerton/Henderson formulation and ours is the first-year discount issue. This will have a slight effect on the absolute level of the estimates but not on the relative levels of the cost of capital for both tax regimes.

(BUDGET FAT, from page 1)

if the economy remains strong until then. Whether a balanced budget would be appropriate, fiscal policy is an important but separate question.

In examining the options for spending reduction, it is useful to divide the budget into a handful of categories representing the major policy choices available to the government. The table on page 4 shows that entitlements and other mandatory spending are the largest portion of the budget. CBO has projected that unless entitlements are cut back, they will account for more than half of all Federal spending by 1992. Defense is another category that has claimed a larger share of the budget, but spending for it is expected to stabilize in the next five years. Interest payments rank third in budget size, but these can only be trimmed through savings in other parts of the budget or more favorable interest rate trends than projected. Discretionary nondefense spending has lost budget share through freezes and retrenchments, but the CBO report strongly suggests that additional savings can be achieved.

Entitlements

Entitlements are not uncontrollable; they can be cut by changing the laws that mandate these payments. It does not suffice, however, to budget for lower entitlements; modifications have to be made in the laws themselves.

CBO has concentrated its deficit-reduction options in the areas where expenditures are projected to grow steeply in the next five years unless the laws are changed.

Medicare Costs

These have tripled from \$25 billion in 1978 to \$78 billion in the current fiscal year and are projected to soar to almost \$140 billion only five years from now. CBO offers eight options for trimming Medicare expenditures. **More than \$4 billion can be saved each year by basing payments on more accurate cost data; another \$15 billion can be saved over a five-year period by requiring beneficiaries to pay 50 percent of the cost of physicians' services—the percentage when Medicare was established—rather than only 25%.** Additional billions can be cut from Federal spending by indexing the deductible paid by Medicare patients for inflation, and by changing the way Medicare reimburses hospitals for medical education and capital investments.

None of these cutbacks would be
(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation

"Variations on a Theme"

Don't raise the bridge. Lower the water." The U.S. Congress is in the process of working a new variation on this old saw. It's called, "Don't cut spending. Raise the deficit reduction targets." Any way you look at it, the suggestion of gutting the Gramm-Rudman-Hollings deficit reduction measure a year after it was passed has to rank as one of the fastest about-faces in history.

Admittedly, it is virtually certain that Congress will not even come close to hitting the \$108 billion GRH target for fiscal 1988. What galls is the rank hypocrisy with which Congress voted GRH, achieved the 1987 target—by its own admission—largely through "blue smoke and mirrors," and then returned home to run for reelection on the basis of its historic budget cutting effort. Nevertheless, politics is the art of the possible, so we must now ask what is possible when it comes to deficit reduction.

Maybe Fed Chairman Paul Volcker had the right idea when he told the Senate Budget Committee last month that he would settle for real reduction of the deficit to \$130 billion in fiscal 1988 instead of a sham reduction to \$108 billion "that realistically is \$150 billion."

The Chairman also made two other points that we—and Congress—should not be allowed to forget: First,

let the \$108 billion GRH target hang out there as evidence of the duplicity with which the fiscal policy process is riddled. Remind Congress of how little credence its promises deserve. Second, make certain that accounting legerdemain and gimmicks such as asset sales are not used in calculating the \$130 billion which the leadership now *claims* is achievable.

Tax Foundation's Shadow Committee on the Federal Budget summarized the situation to date this way in its February 12th report: "The Federal government did not meet the GRH target in 1986, and it will not meet the 1987 target. It is highly doubtful that the \$108 billion deficit level for fiscal 1988 will be met." The only revision needed in that assessment would be to upgrade highly doubtful to "highly probable" that the target will not be met.

Congress has failed to hit the bull's-eye—and is clearly seen to have defaulted on its promise to the American electorate. We may have to settle for merely hitting the target, not the bull's-eye, this time round. But we ought not to allow the politicians to forget that the target did indeed have a bull's-eye and that we know that they missed it by a mile. The public—and the Members—need to be reminded that, if the U.S. Congress gives so little weight to its own commitments, how can they expect us to take them seriously?



TAX FOUNDATION

The Trend in Federal Spending¹
(\$ in billions; % of total spending)

	Actual		CBO Projections			
	1968	1978	1988	1992		
Entitlements	\$ 53	% 30	\$ 220	% 48	\$ 512	% 48
Defense	82	46	105	23	290	27
Interest	11	6	35	8	141	13
Nondefense Discretionary ..	43	24	122	27	185	17

¹Percentages add up to more than 100% because offsetting receipts are not included in the table. Offsetting receipts are budgeted as "negative expenditures."
Source: Congressional Budget Office

(BUDGET FAT, from page 3)

painless. Some costs would be shifted to recipients of medical services; others to providers. But without sizable cuts, Medicare will continue to grow much faster than the rate of inflation and will consume an ever-growing share of the budget.

COLAs

Enormous savings could be realized by limiting the cost-of-living adjustments (COLAs) in various entitlement programs. COLAs drive expenditures up automatically each year. When inflation is high and economic growth low—a situation that occurred in the late 1970s and early 1980s—COLAs cause entitlements to rise much more steeply than Federal revenues. CBO estimates that the incessant rise in entitlement spending can be moderated by restricting COLAs to low-income programs. **Over five years, \$55 billion would be saved by limiting COLAs to two-thirds of the increase in the consumer price index; the savings would be \$77 billion if the COLA was two percentage points below the consumer price increase.**

Agriculture

Spending on agricultural programs has soared well above expected levels in recent years. Farm price support programs now draw about \$25 billion a year from the Federal Treasury. These payments could be reduced by targeting payments to small farmers—most of the money now goes to big producers; by lowering crop support prices; by cutting the link between crop production and income support for farmers. If some of these options were adopted, not only would government spending drop, but the massive crop surpluses would diminish.

Defense Spending

Congress is unlikely to approve major spending reductions that do not take from both "guns and butter." In recent years, Congress has provided much less for defense than the White

House has requested, and the 1988 budget is likely to continue this pattern. **But the Pentagon has sought to stretch its defense dollars without reducing force levels or cancelling major weapons systems.** CBO has devised more than 20 options for reducing defense procurement and moderating the growth in military forces. It suggests that military readiness can be maintained if the variety of aircraft competing for procurement funds were reduced. At the present time, for example, the Air Force is buying two different tactical aircraft (the F-15 and the F-16), is preparing to spend \$27 billion on a new military transport (the C-17) while continuing to invest billions in the C-5 transport, and is upgrading the B-52 bomber while taking delivery of the B-1 bomber and preparing for the next generation's "stealth" bomber.

Similar multiple weapons systems procurement and development are underway in other services. The Army is buying both Apache and Blackhawk helicopters while launching a \$60 billion program for an entirely new aircraft. The Navy is developing a new tilt rotor aircraft while reducing its "buys" of existing aircraft to inefficient levels.

CBO also offers a menu of ideas for cutting research and development costs as well as the amounts spent on military construction and operations and maintenance.

Nondefense Discretionary Programs

Although this category accounts for a declining share of total expenditures, the Federal government spends more than \$180 billion on numerous discretionary domestic programs. CBO identifies a number of opportunities for reducing spending in programs whose goals have either been achieved or could be met with less expenditures. These opportunities include phasing out subsidies for crop and flood insurance; eliminating energy conservation grants; reducing rural electrification subsidies; and cutting back on energy research and development. Over a five-

(FAMILY'S TAXES, from page 1)

government will pay out 32 cents for "income security" programs for each \$1 this taxpayer sends to Washington, a total of \$2,387.

National defense will cost \$282.2 billion—or 27 cents out of each tax dollar. For the moderate-income taxpayer described here, this amounts to \$2,024.

Interest on the public debt ranks third—\$137.5 billion; for this worker, the tab will be \$986, over 13 cents per dollar of taxes.

Health outlays are estimated to total \$111.3 billion—\$798 for the family, or 11 cents for each tax dollar paid.

These four largest programs will claim more than 80 percent of all Federal spending.

However, direct levies account for only about three-fifths of the Federal tax take. To these must be added such indirect taxes as employer's share of Social Security taxes; corporate income taxes; excise taxes on such items as gasoline, liquor and tobacco; and miscellaneous levies. These will take another \$2,951 from the moderate earner's paycheck.

Direct and indirect Federal taxes claim over 26 percent of this family's annual income. But even that does not tell the whole story. All told, current Federal taxes and borrowing add up to nearly 32 percent of this moderate-income family's earnings.

The table on page 1 provides further details.

year period, about \$18 billion could be saved by adopting these and other efficiencies.

Even larger savings could be achieved by ending various subsidies. These include subsidies to the postal service, various power facilities, economic development (EDA) and urban development action grants, and assistance to Amtrak and local transit operations. Finally, billions of dollars can be saved by targeting Federal aid to education, community development grants, and student aid to more needy recipients.

All told, the CBO report demonstrates that Federal spending can be cut. But there is a big difference between devising and implementing cut-back options. **One reason why there is so much to cut from the budget is that so little genuine cutting was done in the past. But if Congress has the will to control Federal spending, the CBO options point to the way that it can accomplish this objective.**

TAX·FEATURES

Tax Freedom Day Is May 4!

2 Hour, 43 Min. Tax Bite From U.S. Worker's Day To Pay 1987 Tax Bill

Taxes will take a 2-hour, 43-minute bite from the average worker's 8-hour earnings in 1987. That's up from 2-hours, 39-minutes in 1986.

Federal taxes will claim 1 hour and 46 minutes of a worker's earnings, while state-local taxes preempt 57 minutes' worth of productive labor. The total tax bite from the workday is far ahead of the next most costly item, housing and household operation, which will require a worker to put in 1 hour and 27 minutes on the job, a minute less than in 1986. Third come food and tobacco, which will consume an hour's worth of work, the same time span as last year.

Researchers at the Tax Foundation detect only minor shifts in the allocation of a day's pay over the last year. Earning the money for the clothing budget will require 23 minutes on the job — the same as in 1986. Other items requiring the same time on the job this year as last include medical expenses (39 minutes), transportation (42 minutes), and recreation (21 minutes).

The higher tax bill this year means that less earning time is available for "miscellaneous" costs, a catch-all category comprising personal care, personal business, private education, religious and welfare activities, net foreign travel, and net savings. This year, the worker will have 3 minutes fewer in the daily 8 hours to work for these items.

The 2-hour, 43-minute tax bite means that today's total tax burden per 8-hour day for 1987 is exactly the same as it was in 1981 prior to the impact of "ERTA" — the Economic Recovery Tax Act of 1981. ERTA caused a drop in the Federal portion of the tax burden, lessening the work times required to cover taxes in 1982, 1983, and 1984. (See Tax Freedom Day story in adjacent column.) This year the cycle comes full course, as subsequent increases in Federal business and payroll taxes have eroded some of the gain from ERTA, and as the total tax take has increased apace with the economic rebound.

The lowest bite from a U.S. worker's eight hours on the job in this decade occurred in 1984, when workers put in 2 hours, 36 minutes to cover their tax bills. That time allocation broke down into 1 hour, 42 minutes for Federal taxes and 54 minutes for state-local collections. Tax Foundation analysts say that, with talk of higher taxes in Washington and the increased need for additional levies at the state-local levels, we are unlikely to enjoy such levels in the foreseeable future. See page 3 for detailed chart.

May 4 is Tax Freedom Day 1987. It takes the average American from January 1 through May 3 to pay the tax collector, assuming every dollar in the paycheck is paid out for Federal, state and local government taxes from the first day of the year.

Economists at the Tax Foundation annually calculate Tax Freedom Day as a way of showing how government dominates the economy. That presence is still growing. Since 1984, the date has moved six days farther on in the calendar—from April 28 to May 4. Tax Freedom Day has advanced two days in just the past year, according to revisions based on updated government data. Tax Freedom Day, 1986, fell on May 2.

This year, the American taxpayer has returned to the same point he was at prior to passage of the Economic Recovery Tax Act of 1981 (ERTA). That legislation stopped the on-going rise of Federal taxes and Uncle Sam's tax take dropped slightly relative to time worked until 1985, when it rose again.

The full impact of ERTA's cuts were never felt. They were diminished by subsequent Congressional take-backs of business tax cuts in 1982 and 1984, higher excise taxes on gasoline and cigarettes, and hikes in payroll taxes instituted to restore the troubled Social Security system to solvency.

At the state-local levels, taxes have generally risen faster than incomes over the past seven years, taking up any slack taxpayers may otherwise have temporarily enjoyed from Federal cuts. The net result is that we are back where we were before ERTA — to a May 4 date for Tax Freedom Day.

The average taxpayer also pays more because of the economy's continuing recovery. Tax collections have risen along with the expanding economy and growing incomes of Americans, causing the flow of revenues to Federal, state and local treasuries to increase as well.

THIS ISSUE:

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Tax Freedom Day

Tax Bite

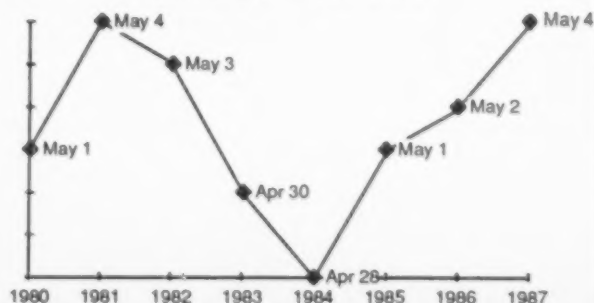
PAGE 2:
Medicare's Growth

Federal Tax Burden

PAGE 3:
"Front Burner"

INSERT:
1987 State Tax Prospects

Tax Freedom Day — 1980 to 1987



The Medicare Miracle: It Grows When It's Cut

Medicare is one of the biggest and fastest-growing Federal programs. At the rate things are going, within a few years, one out of every ten dollars in the budget will be spent on Medicare alone. Moreover, recent proposals by President Reagan to expand Medicare's coverage for catastrophic illness are likely to spur additional spending increases in the years ahead. Yet, despite Medicare's size and growth, Congress has claimed more than \$30 billion in deficit reduction through recent cutbacks in this program. By explaining how Medicare has grown when it has been cut, this article shows why it has been so difficult to make genuine, lasting deficit and spending reductions.

Growth in Spending

In its 20 years of operation, Medicare has greatly improved access for elderly to health services. More than 30 million persons (including 3 million who are eligible on account of disability) are covered by Medicare. But this protection comes with a very high price tag. The following table shows how Medicare has ballooned from a modestly priced program when it was launched in the late 1960s into one of the most costly Federal obligations:

	1967	1972	1977	1982	1987	1992
	actual	actual	actual	actual	est.	proj.
Outlays	\$3.4	\$8.8	\$21.5	\$50.4	\$78.1	\$139.1
% Total						
Outlays	2.2%	3.8%	5.3%	6.8%	7.7%	10.6%
%GNP	0.4%	0.8%	1.1%	1.6%	1.7%	2.2%

Medicare has grown much more steeply than both the overall economy and total Federal outlays. As a result, Medicare spending has almost quadrupled its share of Federal outlays, from about 2 percent in the late 1960s to almost 8 percent at the present time. Similarly, Medicare has grown from less than 1/2 percent of gross national product (GNP) to almost 2 percent. These trends might accelerate in the years ahead, even if Medicare benefits are not enhanced. The Congressional Budget Office's (CBO) baseline projection of the Federal budget under current policy shows Medicare accounting for 10 percent of outlays and 2 percent of GNP in 1992.

Cost escalation has been due to a number of factors. One has been the growing number of elderly, adding more than half a million to the Medicare rolls each year. Another is that inflation is much steeper in the health sector than in the overall economy. In 1986, the general inflation rate was only about 1 percent, but the cost of health services rose about 7 percent. A third factor has been increased utilization of services, because of technological advances and the installation of costly equipment.

1987 Tax Burden Reaches \$818 Billion; CA, NY, and TX Bear Heaviest Loads

The ink may be dry on tax reform, but there has been no reform in the Federal government's voracious appetite for more tax money. The Feds will collect almost \$818.9 billion in taxes during fiscal year 1987, say economists at the Tax Foundation. This is based on the Administration's 1988 budget presented in January 1987, which projects the 1987 figure to surpass 1986 taxes by \$74.3 billion, a ten percent increase.

The effect of the Tax Reform Act of 1986 (TRA86) on income tax distribution is demonstrated by the \$41.6 billion jump in corporate taxes projected for 1987, a whopping 65.9 percent increase over the \$63.1 billion collected in 1986, while individual income taxes will creep up only 4.3 percent, to \$364.0 billion. Social insurance levies will grow to \$296.9 billion, a 6.3 percent rise, and the take from all other taxes will remain almost constant, at \$53.2 billion.

The estimates for 1988 show further growth: \$12.4 billion in additional corporate taxes, \$28.8 billion from individuals, and \$32.7 billion for social insurance purposes.

California, New York, and Texas hold the questionable honor of having the highest tax burdens in the nation, as they have for many years. Just ten states will send more than 58 percent of all the money the Federal government collects in taxes, even though these states house less than 54 percent of the population. These "top ten" account for \$477.5 billion in taxes. In descending order, they are:

CA.....	\$101.4 billion
NY.....	\$ 70.7 billion
TX.....	\$ 57.4 billion
IL.....	\$ 43.4 billion
PA.....	\$ 39.8 billion
FL.....	\$ 39.3 billion
OH.....	\$ 35.2 billion

NJ.....	\$35.0 billion
MI.....	\$31.2 billion
MA.....	\$23.9 billion

These ten states (plus the District of Columbia) represent only 3 percent of the population and bear less than 3 percent (\$22.8 billion) of the Federal tax burden:

ME.....	\$ 3.1 billion
DC.....	\$ 2.9 billion
AK.....	\$ 2.6 billion
ID.....	\$ 2.6 billion
DE.....	\$ 2.5 billion
MT.....	\$ 2.2 billion
ND.....	\$ 2.0 billion
SD.....	\$ 1.8 billion
WY.....	\$ 1.7 billion
VT.....	\$ 1.5 billion

The ten states with the highest per capita tax burdens will kick in \$218.9 billion in taxes, about 26.7 percent of the 1987 total. The average tax burden for their residents will be \$4,100 — 22 percent higher than the national average of \$3,365. Approximately 6.8 percent of the tax burden will be borne by people from the ten states with the lowest per capita burdens, amounting to some \$55.4 billion. Their average burden will be \$2,393 — close to 29 percent below the average for the nation as a whole.

"Top Per Capita"	"Bottom Per Capita"
CT..... \$ 4,904	NM..... \$2,535
DC..... \$ 4,680	AL..... \$2,515
NJ..... \$ 4,588	ID..... \$2,505
AK..... \$ 4,520	SD..... \$2,473
MD..... \$ 4,122	KY..... \$2,466
MA..... \$ 4,093	SC..... \$2,406
NY..... \$ 3,962	WV..... \$2,356
DE..... \$ 3,896	AZ..... \$2,355
IL..... \$ 3,757	UT..... \$2,341
NH..... \$ 3,701	MS..... \$2,031

The table on page 4 provides details of both the total and per capita tax burdens by state, estimated by Tax Foundation economists for fiscal year 1987.

Exaggerated Cutbacks

Congress has been grappling with Medicare for the past decade and it has claimed a great deal of success in controlling the costs of this program. In fact, Congress has taken credit for cutting Medicare in six of the seven years since 1980; it enacted two Medicare cutting laws in 1986. In line with congressional claims, recent full-page newspaper ads sponsored by more than 100 interest groups protested that "during the past 5 years, more than \$30 billion has been cut from Medicare and Medicaid." (Medicaid is the health-care program for low-income persons.) The trend data depict a different

(Continued on page 3)

Tax Features

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State Tax and Fiscal Prospects, 1987

By Elsie M. Watters
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Tax Foundation

The 49 states holding regular legislative sessions in 1987 are facing a heavy volume of tax bills that could lead to a near-record level of statutory tax increases. (Only Kentucky is not holding a regular session.)

Pending measures in 29 states would raise taxes by between \$7 billion and \$8 billion annually, according to a Tax Foundation survey in mid-March. If approved, this would represent the biggest legislative increase in revenues since the \$8 billion increase in 1983.

According to proponents, the new revenues are needed primarily to raise spending for public education and highways, to offset revenue shortfalls due to poor economic performance and declining oil revenues, and to shore up state financial reserves.

Much of the activity involves state response to the 1986 changes in the Federal income tax law, to which most state laws are linked to some extent. More than two dozen states are expected to revise their income tax laws. Most will return to taxpayers any excess taxes that would result from their conformity with Federal law, but some will take advantage of the "windfall" increases.

But the bulk of the new revenues sought will come from other sources, chiefly general sales, motor fuels, and cigarette taxes. Twenty-five states are weighing tax increases that are unrelated to possible "windfalls." Only nine of those 25 states, plus four others, plan to retain excess receipts from Federal tax revision.

The changes under consideration, by type of tax, are summarized below, followed by a state-by-state summary of proposed revisions.

Personal Income Taxes

Personal income taxes will be the most revised type of tax in 1987. At least 22 states plan changes in their laws, and another state — Alaska — may levy a new income tax. Most of the states (19) will modify exemptions, deductions, and/or state rates and brackets so as to return all or a portion of the excess taxes that would otherwise result from state linkages to Federal law. These are: Arizona, California, Connecticut, Delaware (part), Georgia (part), Hawaii, Kansas (part), Maine, Maryland (part), Michigan, Minnesota, Montana, New York, Ohio (already enacted rate cuts in 1986), Oregon, South Carolina, Virginia (most), West Virginia, and Wisconsin.

On the other hand, at least 11 states plan to retain any "windfall" increases resulting from Federal tax revision. Three of them — Arkansas, Indiana, and Iowa — would revise their laws to do so, either by linking their taxes more closely to the Federal tax or by updating earlier linkages. Eight others are already linked to the "current" Federal Tax Code and need take no action to avert the "windfall." These are: Colorado, Idaho, Illinois, Louisiana, Missouri, New Mexico, Oklahoma, and Utah.

In addition to action or inaction in response to the Federal tax changes, several states plan base or rate changes in personal income taxes: Illinois (higher rates), New Mexico (limiting existing rebates), and Utah (repealing deductibility of the Federal tax). Reduction in rates (separate from action on the "windfall") may be approved in New York and in Rhode Island (where the tax rate is linked to Federal tax liability and has been adjusted to avoid a revenue loss).

North Dakota and Vermont have already raised their tax rates to avoid losses and Nebraska is planning other revisions to avoid losses.

Corporate Income Taxes

Fewer changes are under consideration concerning the disposition of "windfall" increases in corporate income taxes resulting from Federal tax reform. Two states — Louisiana and Ohio — took action in 1986 to avert any increases. In nine other states, governors have proposed that excess receipts be returned to taxpayers: Arizona, California, Maine, Montana, New York, North Carolina (where legislators are unlikely to go along), Oregon, South Carolina, and Wisconsin.

In another 12 states, governors and/or legislative leaders are recommending that the states retain any revenues resulting from Federal tax revision, often along with changes requiring closer conformity with the new Federal Tax Code. These are: Arkansas, Colorado, Florida, Georgia, Idaho, Iowa, Kansas, Minnesota, Missouri, New Mexico, Oklahoma, and Utah.

General Sales Taxes

General sales taxes are likely to be the source of the greatest revenue gains from legislation in 1987. Montana, one of only five states without a general sales tax, may enact one. Fourteen others expect to gain more money from the sales tax, either through base-broadening (sometimes coupled with rate cuts) or rate increases. These include: Arkansas, Florida, Idaho, Illinois, Indiana, Minnesota, Missouri, Oklahoma, South Dakota, Texas, Utah, Vermont, Washington, and West Virginia. Temporary increases in sales taxes may be extended or made permanent in Idaho and Texas.

Motor Fuels Taxes

The need for added highway funding is likely to lead to legislative increases in motor fuels taxes in at least 14 states. States considering such legislation include: Alaska, Florida, Idaho, Illinois, Iowa, Maryland, Michigan, Mississippi, Missouri, Montana, Nevada, New Mexico, Oklahoma, and Utah. Texas may extend a temporary increase.

Other Taxes

Seven states have reported plans to consider cigarette tax hikes: Idaho, Iowa, Montana, Nebraska,

North Dakota, Oklahoma, and Utah. In addition, ten states are considering other types of increases.

Alabama. The governor called for a serious study of the state's tax system so that a "meaningful and just" program of tax reform could be considered. The Alabama legislature does not convene until April 27.

Alaska. The governor proposed \$425 million a year in higher taxes, including imposition of a personal income tax, higher taxes on motor fuels and the oil industry, and increases in various licenses and fees. He also urged repeal of the state's unitary tax on multinational corporations and of homeowner property tax exemptions. Because of declining oil revenues, deficits for 1986 and 1987, combined, are estimated at \$875 million. Earnings of the Alaska Permanent Fund will be used to meet part of the deficit.

Arizona. The state's leaders favor adjusting state income taxes to avoid an estimated \$140 million increase (personal and corporate) as a result of Federal tax reform. The governor has pledged to repeal the added 1 percent sales tax enacted in 1983.

Arkansas. The governor proposed new revenues totaling \$185 million in 1988, largely for public schools. The funds would come from conforming state taxable income (individual and corporate) to the Federal Code, broadening the base of the sales tax, higher taxes on wine and beer, and other sources.

California. The governor proposed no tax increases and said that he supports greater conformity with the new Federal Tax Code, including fewer brackets and lower rates. There will be pressures to raise taxes (retail sales, excises) to obtain more money for education and highways, but the state is facing effects of a spending limitation approved by the voters in 1979; efforts are being made to ease the limit.

Colorado. The governor has asked the legislature to take no action to avert an estimated \$200-\$300 million personal and corporate Federal tax "windfall." The governor also expressed concern about the "dramatic shift in tax burden from state government to local governments" in Colorado.

Connecticut. The governor wants to continue taxing capital gains at the same effective rate as previously to avoid a \$150 million "windfall" increase. Another large pending surplus is generating proposals for reducing the 7 percent sales tax and for offsetting the "windfall" rise in corporate income taxes, as well as for new and expanded spending programs.

Delaware. The governor has proposed tax adjustments as of January 1, 1988, to offset partially the Federal "windfall," by cutting the number of brackets from 14 to 9, by increasing the exemptions and standard deductions, and by reducing the top marginal rate from 8.8 percent to 7.8 percent.

Florida. The governor proposed reducing the sales tax rate from 5 percent to 4.5 percent along with extensive broadening of the sales tax base, and increases in insurance levies. He also asked that cities and counties be authorized to impose local option sales taxes of up to 1 percent. He urged that Florida's

corporate income tax be revised to conform to the new Federal law. (Florida has no personal income tax.) The "windfall" from the corporate tax as a result of Federal tax reform is estimated at \$58 million. Other likely tax increases include motor fuels levies.

Georgia. The governor announced his support for a measure that would bring the state's income tax system substantially in line with the new Federal law, and a law has been enacted to that effect. He suggested reducing personal income taxes by about \$50 million (averting an estimated \$250 million "windfall" from Federal revisions) by raising exemptions and standard deductions. The plan would raise corporate taxes by about \$70 million.

Hawaii. The governor proposed a restructuring of the state's tax system, including changes in tax rates and brackets, to minimize the impact of Federal tax revision. He also asked for a \$50-per-person food tax credit against income tax.

Idaho. The legislature has approved the governor's plan for making the "fifth cent" of the sales tax permanent. The governor also proposed that the state's personal and corporate taxes be conformed to the new Federal law (including repeal of the investment tax credit) and that the state retain the \$22 million "windfall" that would result from conformity. Other proposals include increasing cigarette and motor fuel taxes. There is a question as to whether lawmakers will approve repeal of the investment tax credit.

Illinois. The governor's budget called for a \$1.6 billion tax hike in fiscal 1988, to balance the state budget and allow higher spending for education, wastewater treatment facilities, and highways. His plan includes increases in personal income tax rates, broadening the sales tax base, and raising gasoline taxes and auto and truck license fees.

Indiana. The governor wants tax increases to support education. He proposed cutting the sales tax rate from 5 percent to 4.5 percent, while broadening it to cover services (for an additional \$300-plus million over two years). The legislature is expected to approve the governor's recommendation for conforming personal and corporate taxes to the new Federal law and retaining the \$50 million a year "windfall."

Iowa. The governor proposed significant changes in personal income taxes: eliminating deductibility for Federal taxes paid, reducing the number of brackets from 13 to 2. He also asked for a hike in motor fuels and cigarette taxes. Action is pending to conform the state tax to the new Federal Code and thereby raise state revenues by \$145 to \$190 million.

Kansas. The governor recommended minimal tax code changes in 1987, because of uncertainty over the actual impact of Federal tax reform on state revenues. He said that major reform could come later. Possible tax changes in 1987 include reductions in personal and corporate income tax rates and exempting manufacturing machinery and equipment from the sales tax. The state may return part — but not all — of the "windfall" increase from Federal tax reform.

Louisiana. The state constitution prohibits tax

increases in odd-numbered regular sessions of the legislature; a special session may be called to consider the governor's proposed hike in the state property tax. Louisiana expects to retain a 12.5 percent increase in personal income tax revenues owing to Federal tax revisions; adjustments to avoid effects on state corporate tax revenues were enacted in 1986.

Maryland. The governor proposed using most of the "windfall" from Federal tax reform for education and social programs and the rest for reducing taxes for lower-income persons. Legislative leaders, on the other hand, drew up plans to return nearly all of it to taxpayers. A compromise bill would return to the taxpayers about 68% of the estimated \$178 million "windfall." The compromise contained provisions aimed at the poor, as well as retaining a 40 percent exclusion for capital gains. The governor also proposed an increase in the gasoline tax, to pay for highway improvements.

Massachusetts. The governor recommended updating the existing linkage in the state code to the new Federal Code. The revenue effect is expected to be negligible. The governor also proposed expanding the investment tax credit from 1 percent to 4 percent, with further restrictions on its use.

Michigan. The governor recommended a reduction in the state personal income tax rate from 4.6 percent to 4.4 percent to avert a \$155 million "windfall." The motor fuels tax will probably be increased.

Minnesota. The governor proposed comprehensive tax reform, along with state tax increases totaling \$629 million for the 1988-89 biennium. He would return an estimated \$660 million "windfall" from Federal tax revision to the taxpayers. The governor's plan would raise corporate income taxes by \$151 million for the biennium through closer conformity to the Federal tax, despite a rate reduction. Additional new revenues would come from broadening the sales tax base, from higher utility and insurance premiums, and other sources.

Mississippi. The governor called for no new or higher taxes. The legislature, however, overrode his veto of a bill to raise motor fuels taxes and license fees to pay for increased highway spending.

Missouri. The governor proposed higher personal and dependency exemptions for personal income taxes, but urged that no alteration in the state tax system be made in anticipation of a possible "windfall" from Federal tax reform, since amounts were highly uncertain. Other proposals would raise the rates of general sales and motor fuels taxes.

Montana. The legislature is likely to consider enactment of a general sales tax (Montana is one of only five states without one), along with hikes in taxes on cigarettes, tobacco, and motor fuels and new taxes on soft drinks, hotels, and motels. Legislation has been introduced to avert a "windfall" of \$35 to \$45 million from Federal tax revision, but the state faces such a deficit that the "windfall" is likely to be retained.

Nebraska. The governor recommended that the state's individual income tax (levied as a percent of

Federal tax) be adjusted so as to yield the same amount as under current law. Lawmakers are leaning toward linking the state tax to Federal adjusted gross income and eliminating all itemized deductions except medical expenses. They have approved a cigarette tax hike.

Nevada. The governor proposed raising the tax on gross gaming revenues and retaining a 3 percent insurance premiums tax that is scheduled to expire. Other proposals would hike motor fuels taxes and increase motor vehicle registration fees. Local governments are said to be pushing for removal of current revenue-raising restrictions; and educators at all levels are reported to be seeking dramatic pay increases and higher taxes to support them.

New Hampshire. The governor proposed no tax increases. Hearings were held on a bill to cut the business profits tax from 8.25 percent to 7.5 percent on July 1, 1987, instead of to 8 percent as scheduled under current law; action has been deferred until 1988.

New Jersey. The governor proposed no tax increases. The state's personal income tax is not linked to the Federal revenue code.

New Mexico. The governor recommended increases in taxes and fees totaling \$159 million, as well as state retention of an estimated \$59 million "windfall" in personal and corporate income taxes that would result from automatic conformity to Federal law. The legislature has approved most of the governor's plan, which included increases in personal income taxes (limiting food and medical rebates), motor vehicle excises, gasoline taxes, and other user fees.

New York. The governor recommended legislation to return to taxpayers the \$1.67 billion "windfall" from Federal tax reform. In addition, he proposed converting the state's sales tax on automobiles to an ad valorem tax which would be deductible in computing Federal tax; to administer the new tax, he would raise funds by increasing and broadening the state's mortgage recording tax in the Metropolitan Transit Region. In early March, the governor announced that he would support tax reductions totaling \$1.7 billion over five years, beginning in 1987.

North Carolina. The governor said that he would like to return to the taxpayers any corporate tax "windfall" increase due to Federal tax revision, but legislative leaders appear unwilling to do so. The state's personal income tax does not conform closely to the Federal tax; current legislative proposals, however, would base the state tax on Federal taxable income.

North Dakota. In December 1986, the legislature raised the personal income tax from 10.5 percent to 14 percent of Federal tax liability, to more than offset an automatic loss from Federal tax reform and raise an extra \$57 million over the next two years. (The hike came under fire and was referred to the voters, who approved it by a razor-thin margin.) The legislature has also approved a bill to raise the cigarette tax.

Ohio. The governor and legislative leaders have pledged that there will be no tax increases in 1987. Last December, the state enacted legislation to avert a \$303 million "windfall" (in 1988) from Federal tax revision.

Both personal and corporate tax rates were cut. There is a trigger system in the law, however, designed to restore all or a portion of the personal income tax reduction in 1988 if the revenue impact of the Federal revision is 15 percent below the estimate for 1987.

Oklahoma. In March, the governor submitted revised tax proposals, recommending \$248 million in higher taxes. He asked for increases in the sales tax rate and base and in the levies on motor fuels, cigarettes, and alcoholic beverages. Oklahoma is expected to retain the Federal "windfall."

Oregon. The governor asked for conformity to the new Federal Code, but "without nicking Oregonians for added taxes." "Windfall" receipts of \$170 million a year are expected. The legislature is likely to reduce income tax rates, although there will be proposals to use some or all of the "windfall" to reinstate programs or establish a "rainy day" fund.

Pennsylvania. The governor wants to use nearly all of an estimated \$261 million surplus for basic education. Opposition legislators are calling instead for cuts in personal and corporate income taxes. The state's personal tax is not linked to the Federal Code, but the state stands to pick up a "windfall" from the corporate tax unless changes are made.

Rhode Island. In 1986 the personal income tax rate was raised from 22.21 percent to 23.96 percent of Federal tax liability, to avoid a loss of \$24 million in fiscal 1987. The governor has asked that the tax rate be cut, to save taxpayers \$19 million in fiscal 1988.

South Carolina. Saying that the state's taxes had been raised 11 times in the past seven years, the governor proposed no tax increases and a new limit on general fund spending. In 1985, South Carolina conformed its state income taxes with Federal laws, and the governor wants to continue that linkage, with some adjustments.

South Dakota. The governor has signed legislation increasing the sales tax rate from 4 percent to 5 percent (for one year) and repealing the sales tax exemption for cigarettes.

Tennessee. The governor called for no new taxes and warned legislators that, if they want spending increased, they must come up with new taxes to pay for them. Absent action by the state, Federal tax reform will raise state corporate income taxes by an estimated \$350 million over the next five years.

Texas. The state faces a \$1 billion deficit at the end of the current biennium, and it is estimated that available revenues for the 1988-89 biennium will fall \$5.8 billion short of the amount needed to retire the current deficit and adopt a "current services" budget. The governor has proposed continuing temporary general sales and motor fuels tax increases (for \$2.9 billion in the forthcoming biennium), along with the sale of surplus state land and other nontax sources and fund transfers to augment general fund revenues. Attention is also being given to broadening the sales tax base to include services, as well as to raising the sales tax rate from 5.25 percent to 6 percent to raise \$750

million for improving the state's prison system.

Utah. The legislature has approved most of the governor's proposed \$200 million tax increase, including hikes in individual income taxes (by denying Federal tax deduction), motor fuels, general sales, and cigarette tax rates. The state expects to retain most of a \$58 to \$60 million Federal "windfall."

Vermont. An increase in the personal income tax rate — from 25 percent to 25.8 percent of Federal tax liability — has been approved. Legislative leaders have been moving toward an increase in the state sales tax to boost aid for poorer school districts.

Virginia. Legislation approved in February will return to personal income taxpayers about \$145 million of an estimated \$173 million "windfall" from Federal tax reform. The new state law increases the standard deduction and personal exemptions and raises the threshold at which the lowest and highest rates apply. For corporations, the law recoupled state provisions with Federal asset depreciation schedules. The governor said he would earmark the remaining \$28 million of the "windfall" as a special "tax reform reserve," to be returned later if revenue estimates prove accurate.

Washington. The governor proposed tax increases totaling \$510 million over the next two years in state taxes and \$272 million in local taxes. The new funds would be used to finance education improvements. The governor's plan includes broadening the base of the sales tax to include most services, while reducing the rate from 6.5 percent to 6 percent. Other changes involve revisions in the business and occupation tax.

West Virginia. The governor proposed returning to taxpayers \$24 million of an estimated \$47 million "windfall" from Federal tax reform and using the rest to help balance the budget. The legislature, however, approved a bill — awaiting the governor's signature — that would return all of the "windfall" and raise taxes by \$43 million, mainly through taxing more business purchases under the sales tax. Lawmakers also approved a new payroll tax on employers and workers to help pay off the state's large debt to the Federal unemployment compensation fund.

Wisconsin. The governor proposed that the state income tax be conformed in most respects to changes in the new Federal law. He would use the estimated \$164 million "windfall" from the personal income tax to cut rates across the board by 3.5 percentage points, to retain the 60 percent capital gains exclusion, and to phase out the inheritance and gift taxes over four years. He asked that the state's corporate income tax also be conformed to the Federal changes, but in a revenue-neutral way. Opponents of the governor's plan want to double the governor's proposed personal income tax cut, but pay for it by taxing 100 percent of capital gains.

Wyoming. The governor asked for a constitutional amendment to establish a controlled, limited tier (classified) system of property taxation, with a limit on the allowable difference between tiers. He also called for changes in taxation of natural resources.

(MEDICARE, from page 2)

situation, however. Rather than shrinking, Medicare spending is \$30 billion higher than it was just five years ago. While some cutbacks have been made, the spending escalation has not been halted. Here are some reasons why Medicare grows when it is cut:

- The size of the cuts has been greatly exaggerated by Congress. Increases in Medicare premiums are lumped together with program changes in computing the size of the cuts. The justification for this is that both increased charges and program cutbacks contribute to deficit reduction. But this practice creates a misleading impression of much deeper cuts than have actually been made.

- The cutbacks are computed in terms of a hypothetical baseline of the amount of spending that would occur if no program changes were made. The baseline projections enable Congress to define rising expenditures as program cutbacks. The baseline assumes the inflation and utilization rates expected in health care over the next several years. Savings are realized only to the extent that these assumptions turn out to be valid. It is highly probable that savings have been substantially overstated in recent years.

- Congress is very adept in counting temporary changes as permanent savings. When it froze hospital payments for one year and physicians' fees for 15 months, Congress took credit for billions of dollars in deficit reduction, even though it did not cut a single dollar from the Medicare budget. Temporary cuts — unlike permanent ones — can be double-counted: first when the temporary provision is enacted; and again when it is renewed.

- Congress has resorted to gimmicks that produce paper savings without really cutting expenditures. It can defer payments from one year to future years and count the lower spending as a cutback. A few years ago, for example, Congress tampered with the Julian calendar by providing that Medicare would have 11 months in fiscal 1981 and 13 months in fiscal 1982.

- There is growing evidence that the recent changes in Medicare have resulted more in behavioral changes by providers of health care than in dollar savings. Despite freezes in hospital payments and a shift from cost reimbursement to a prospective payment system, the profit margins of hospitals for Medicare services have been much higher in the past few years than before these assumed cutbacks were made. Despite freezes and caps on physician fees, the cost of this part of Medicare is also rising much more rapidly.

The Medicare Time Bomb

Medicare is a "time bomb" that threatens to bankrupt the system of health care for the elderly. At the present rate, the Medicare trust fund will run out of

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation

"The Circle Closes"

Each year Tax Foundation economists calculate how long the typical worker must spend on the job in order to meet Federal, state and local tax obligations. They do this, not out of a perverse desire to engage in tax-collector bashing, but because the Foundation's fundamental reason for being is to educate the American taxpayer public on the size and weight of government on the overall economy.

This year, the news is not pleasant. In 1987, the average American will spend 2 hours, 43 minutes on the job to keep the tax collectors happy. This puts us exactly where we were in 1981. It has taken just six years to undo the revenue giveback of ERTA, the so-called Reagan tax cut. The good news is that without those cuts, we'd be working even longer for the tax man.

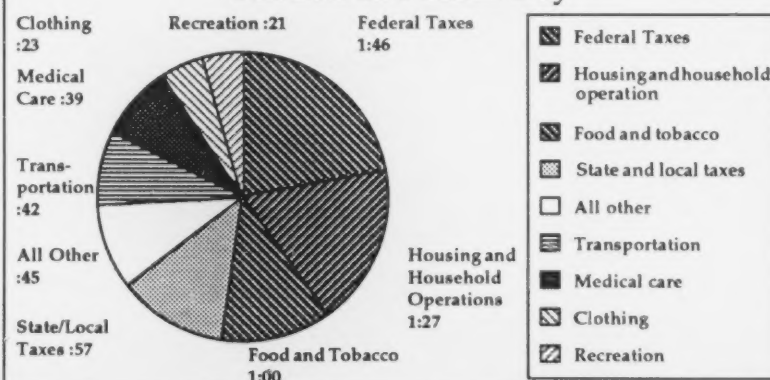
The circle has closed — but with a difference. In 1981, the average worker

spent 1 hour, 52 minutes to pay Federal taxes and 51 minutes to pay state-local levies. This year, the ratio shifts to 1 hour, 46 minutes for Uncle Sam and 57 minutes for the states and localities.

The shifting in funding of a number of Federal programs has helped move the tax burden from Washington closer to home. State and local officials and taxpayers must now choose which of those programs they want and must find ways to pay for them. Quantitatively, they have chosen to pick up virtually all the costs Uncle Sam has laid down. There have been changes in priorities although space does not permit us to detail their extent.

Two fundamental principles of public finance, however, remain intact: There's no free lunch. You get what you pay for and, conversely, sooner or later, you pay for what you get.

Tax Bite in 8-Hour Day



money around the turn of the century and huge tax increases or transfers from the Social Security trust fund will be required to keep it afloat.

The inflationary conditions that have beset Medicare are likely to persist and possibly worsen in the future. The elderly — especially those over 75 — will constitute a growing portion of the population, and the utilization of medical services — especially long-term care in nursing homes and other expensive facilities — will increase. Congress is likely to enact a catastrophic health insurance plan this year, and many see this as opening the door to further expansions in the years ahead.

Demographic changes will impel large spending increases in Medicare, but the size of these increases can be moderated by more realistic congressional budget actions:

1. Congress should not exaggerate the size of cutbacks and should stop counting bookkeeping tricks as deficit reductions;

2. Congress should base program improvements on realistic cost estimates. The history of Medicare has consistently shown costs exceeding estimates made out of political expediency;

3. Congress should trade off program improvements for changes in the current structure of Medicare. One option would be to have patients pay a higher share of the cost for routine care while increasing the government's assistance for acute illness.

Past performance offers little grounds for optimism that Congress will take these steps. But Medicare is a program that may be running out of miracles. If it does, and if the Congress fails to act in time, the verdict will be, "The program was successful but the patient couldn't afford to pay the bill."

**ESTIMATED TOTAL AND PER CAPITA
FEDERAL TAX BURDENS BY STATE, FY86 — FY88**

State	Total Burden (Millions)			Per Capita Burden			Rank 1987	
	1986	1987	1988	1986	1987	1988	Total	PerCap
TOTAL	\$744,578	\$818,856	\$894,258	\$3,090	\$3,365	\$3,639	—	—
AL.....	9,340	10,227	11,167	2,311	2,515	2,731	24	43
AK.....	2,394	2,595	2,830	4,377	4,520	4,693	44	4
AZ.....	8,944	9,876	10,804	2,725	2,920	3,100	26	33
AR.....	5,038	5,558	6,077	2,136	2,355	2,574	32	49
CA.....	92,012	101,362	110,712	3,422	3,694	3,954	1	11
CO.....	10,588	11,657	12,734	3,210	3,462	3,704	23	13
CT.....	14,281	15,674	17,117	4,485	4,904	5,337	17	1
DE.....	2,251	2,462	2,692	3,590	3,896	4,220	46	8
FL.....	35,440	39,348	42,997	3,031	3,269	3,470	6	23
GA.....	16,266	17,869	19,545	2,678	2,893	3,112	13	34
HI.....	3,082	3,395	3,715	2,878	3,118	3,356	40	26
ID.....	2,332	2,575	2,814	2,295	2,505	2,706	45	44
IL.....	39,545	43,441	47,393	3,425	3,757	4,093	4	9
IN.....	15,229	16,757	18,317	2,771	3,049	3,333	15	29
IO.....	7,605	8,432	9,210	2,644	2,939	3,217	28	31
KS.....	7,491	8,260	9,027	3,039	3,329	3,615	29	20
KY.....	8,396	9,241	10,090	2,248	2,466	2,685	27	46
LA.....	11,336	12,418	13,546	2,530	2,770	3,020	22	37
ME.....	2,845	3,140	3,431	2,429	2,666	2,895	42	40
MD.....	16,764	18,361	20,056	3,791	4,122	4,469	12	5
MA.....	21,764	23,938	26,147	3,731	4,093	4,460	10	6
MI.....	28,534	31,248	34,061	3,154	3,467	3,795	9	12
MN.....	12,880	14,204	15,535	3,058	3,355	3,651	20	18
MS.....	4,896	5,375	5,870	1,862	2,031	2,204	33	51
MO.....	14,838	16,383	17,910	2,941	3,234	3,521	16	24
MT.....	2,000	2,213	2,417	2,401	2,634	2,851	47	41
NE.....	4,491	4,980	5,455	2,786	3,078	3,359	34	28
NV.....	3,124	3,419	3,722	3,241	3,443	3,641	39	15
NH.....	3,458	3,804	4,160	3,414	3,701	3,988	38	10
NJ.....	31,909	35,008	38,197	4,202	4,588	4,983	8	3
NM.....	3,481	3,825	4,183	2,354	2,535	2,718	37	42
NY.....	64,161	70,716	77,271	3,602	3,962	4,320	2	7
NC.....	15,939	17,476	19,093	2,521	2,732	2,951	14	38
ND.....	1,790	1,976	2,156	2,591	2,835	3,067	48	35
OH.....	32,030	35,179	38,411	2,986	3,284	3,591	7	22
OK.....	9,106	9,975	10,881	2,716	2,926	3,141	25	32
OR.....	7,298	8,059	8,802	2,708	2,979	3,243	31	30
PA.....	36,306	39,848	43,454	3,066	3,367	3,674	5	17
RI.....	3,059	3,363	3,671	3,150	3,449	3,749	41	14
SC.....	7,523	8,259	9,031	2,220	2,406	2,597	30	47
SD.....	1,586	1,766	1,935	2,230	2,473	2,699	49	45
TN.....	11,984	13,141	14,365	2,501	2,725	2,959	21	39
TX.....	52,461	57,402	62,665	3,123	3,328	3,539	3	21
UT.....	3,666	4,024	4,398	2,181	2,341	2,502	36	50
VT.....	1,384	1,526	1,664	2,567	2,805	3,036	51	36
VA.....	18,228	20,065	21,946	3,158	3,435	3,711	11	16
WA.....	13,718	15,079	16,448	3,076	3,341	3,601	18	19
WV.....	4,135	4,542	4,955	2,140	2,356	2,574	35	48
WI.....	13,448	14,816	16,168	2,811	3,089	3,363	19	27
WY.....	1,537	1,684	1,837	2,978	3,215	3,453	50	25
DC.....	2,660	2,906	3,168	4,270	4,680	5,125	43	2

Source: Total taxes as shown in the Federal budget submitted January 1987; computations of total and per capita tax burdens by state were made by Tax Foundation.

TAX·FEATURES

Cost of Congress Tops \$2 Billion, As Legislators Raise Their Pay 16%

TF's Shadow Budget Committee Calls on President and Congress To Work Together to Cut Deficit

Cooperation, realism, and a deficit reduction mechanism with teeth are needed "to bring significant, real deficit reduction," Tax Foundation's Shadow Committee on the Federal Budget maintained in its May 8th report. Charging that the recent turbulence in financial markets adds urgency for progress, the report stated, "a lower deficit would ease dependence on foreign lenders, slow the rise in interest payments, facilitate accommodations with trading partners, and contribute to overall economic stability."

The Committee detailed three elements that must coalesce if progress toward bringing down the deficit is to be real and lasting:

- "The President and Congress should work to reconcile their divergent budget policies and endorse concrete actions that would turn their promises of lower deficits into reality."
- "The President and Congress should adopt realistic deficit targets for the 1988 fiscal year based on credible economic forecasts and program assumptions."
- "The G-R-H and congressional budget process should be strengthened to ensure more effective enforcement of budget decisions, deficit levels, and budget priorities."

"Pressure for budget negotiations may escalate in the coming weeks as Congress faces the need to raise the debt limit and as fresh efforts are made to revitalize the G-R-H process," the report concluded. "As part of an agreement on the budget, Congress and the President should devise strengthened procedures for meeting the deficit targets. Just setting new targets without effective enforcement will not enhance fiscal responsibility."

Members of the Shadow Budget Committee are The Honorable Harry F. Byrd, Jr., W. Bowman Cutter, Paul H. O'Neill, Rudolph G. Penner, and Allen Schick. The report, "Reducing the Deficit when Growth Slackens," is available from the Tax Foundation for \$4, plus \$1 for postage and handling.

The U.S. Congress gave itself a 16 percent pay raise in March. Members' salaries jumped from \$77,400 to \$89,500, and a half-dozen congressional leaders will get even more.

Consequently, it comes as no surprise to Tax Foundation economists that, overall, spending on the Legislative Branch will rise by 28 percent in fiscal 1987. That's the estimated increase — \$467 million — contained in the budget the President submitted in January. Total 1987 costs are put at \$2.1 billion, up from less than \$1.7 billion in fiscal year 1986.

At a 28 percent growth rate for fiscal 1987, the cost of Congress is sharply outpacing the overall trend of 3 percent for Federal spending this year. Congress will cost taxpayers twice as much as it did ten years ago and more than eight times 1967 levels.

In 1977, the Tax Foundation published a study warning that Congress was becoming "The Next Billion Dollar Bureaucracy." Within two years that prediction had become fact, when Federal outlays broke the \$1 billion barrier in 1978. At current rates of increase, Congress as a "\$3 Billion Bureaucracy" is just around the corner.

The 1988 budget includes a supplemental request for nearly \$34 million in 1987 appropriations for increased pay costs for the Legislative Branch and over \$54 million for increased costs of retirement contributions on behalf of Members of Congress and their staffs.

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Outlays for the Legislative Branch of the Federal Government by Unit
Selected Fiscal Years 1966—1987(a)
(Thousands)

Unit	1966	1976	1986	1987
Total	\$231,505	\$775,366	\$1,664,516	\$2,131,457
Congress, total	111,865	374,122	849,931	1,020,476
Senate	35,388	123,851	273,223	331,713
House of Representatives	68,095	197,525	470,741	574,722
Joint activities	8,382	52,746	105,970	114,041
Legislative agencies, total	119,640	401,244	814,582	1,110,981
Architect of the Capitol	26,158	57,281	94,696	188,893
Botanic Garden	497	1,235	2,107	2,267
Congressional Budget Office	—	2,763	15,678	17,853
General Accounting Office	46,136	131,778	288,533	307,546
Government Printing Office	21,662	93,391	56,423	114,676
Library of Congress	25,187	117,193	334,335	442,668
Office of Technology Assessment	—	5,035	14,309	16,474
U.S. Tax Court	—	6,919	22,147	26,387
Other	—	1,447	1,984	3,082
Deductions for offsetting receipts	—	-15,798	-15,630	-8,865

(a) Data for 1987 are estimates from the Budget presented in February 1987
Source: Office of Management and Budget

One Trillion Dollars of Federal Loans But No Such Thing As Free Credit

The Federal government operates huge credit programs that cost taxpayers billions of dollars. Each year, the government makes or guarantees approximately \$200 billion of new loans to farmers, homeowners, businesses, students, and many other borrowers. Right now, about \$250 billion in direct loans and \$450 billion in guaranteed loans are outstanding; an additional \$450 billion has been lent by government-sponsored enterprises such as the Farm Credit System.

Costless Assistance?

One reason why credit assistance is popular is that beneficiaries often claim (and governments sometimes pretend) that it is costless. Credit programs are not costless. They have two basic features of regular expenditures: a cost to the government and a benefit to recipients. The cost and benefit depend on the terms of the assistance and on the financial condition of the borrower. A loan provided at an interest rate below the government's own borrowing costs will be more expensive to taxpayers than one provided at the same rate; a guarantee that eventuates in default will cost more in public outlays than one which does not lead to government payment.

Direct loans

The Federal government issues more than \$40 billion in direct loans each year. Unlike businesses, which count loans as assets, the Federal government budgets these loans as outlays. Thus, total budget outlays include new loans minus the repayment of old loans.

In recent years, Congress has installed a credit budget in an effort to control the amount of direct loans obligated each year. The credit budget process consists of two parts: (1) Each budget resolution adopted by Congress sets forth a total amount that may be obligated in direct loans during the fiscal year and allocates it among the various functions in the budget. (2) The amount of loans that may be obligated for particular programs is limited in appropriation bills. However, these limitations have not been effective in controlling credit programs where eligible persons have a legal right to borrow from the Treasury.

Direct loans usually provide a number of subsidies to borrowers, the largest of which usually derive from charging interest rates below market levels. Direct loans are also subsidized by deferring interest payments, waiving loan fees, allowing grace periods to borrowers who do not repay on time, and lending funds to high-risk borrowers who could not get commercial loans.

Although it is difficult to compute the subsidy value of these loans, the Office of Management and Budget (OMB) has estimated that they add up to about \$8 billion a year. OMB has proposed a credit reform that would make the subsidy value of these loans explicit. The government would discontinue the practice of recording the face value of new loans as an outlay in the budget; instead, it would resell these loans to

(Continued on page 3)

General Sales Biggest Tax Source for States

Sales taxes still bring in the most money for the states, according to recent analysis by the Tax Foundation. Economists at the Washington-based tax watchdog organization say that general sales taxes, which are levied by 45 states, brought in \$74.8 billion to state treasuries in fiscal year 1986 — nearly one-third (32.8 percent) of all state tax collections for that year.

Second as a major revenue raiser was the personal income tax, bringing in \$67.5 billion in fiscal 1986 for 29.6 percent of total tax receipts. Corporate income taxes, the third largest single tax source, amounted to \$18.4 billion, 8.1 percent of the total. Only five states (Nevada, South Dakota, Texas, Washington, and Wyoming) have neither a corporate nor a personal income tax, and only seven states (the previous five plus Alaska and Florida) have no individual income tax.

All 50 states tax gasoline and motor fuels, which brought in \$14.1 billion (6.2 percent) of total taxes in fiscal 1986.

All states have local property taxes, and 41 have state property taxes; 39 states have both general sales and income taxes; and 33 states have general sales, income, and property taxes, Tax Foundation economists say.

State Sales Taxes

Connecticut led the list for top rates with its 7.5 percent sales and use tax rate, followed by: Washington (6.5 percent); Minnesota, Mississippi, New Jersey, Pennsylvania and Rhode Island (6 percent); and Nevada (5.75 percent).

(Continued on page 4)

(COST OF CONGRESS, from page 1)

The pay and benefits increase was recommended by the President and automatically takes effect, absent action by Congress. In 1985, Congress turned over to the Chief Executive the power to set congressional salaries unless two-thirds of both houses reject his recommendation within 30 days. The Senate voted overwhelmingly in January to block the pay hike, but the House waited until a day after the legally mandated deadline before voting to refuse the proposed salary increase, so the raise automatically went into effect.

The bill for running the Congress itself (Senate and House) will exceed \$1 billion in 1987, 20 percent more than last year. The Senate will cost taxpayers \$332 million (\$3.3 million per Senator), while the House will require

\$547 million (\$1.3 million per U. S. Representative).

Congress also maintains a number of legislative agencies that will spend a total of \$1.1 billion in 1987, 36 percent higher than last year. Two of these agencies — the Architect of the Capitol and the Government Printing Office — will double their budgets; and the budgets of nearly all other legislative agencies also show substantial increases.

Congress has been patting itself on the back for holding mail costs at last year's \$95 million level. There will be considerably less chortling next year — an election year — when official mailings are expected to cost \$134 million, more than 40% above 1987 allowances.

Will Rogers once said the American taxpayer should be grateful they're not

getting all the government they're paying for. He didn't say, however, they should be grateful to be paying so much for the kind of government they were getting.

Tax Features

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

MAY/JUNE 1987

More Battles Over Tax Burdens

Summary

- Because of the deficit and other factors, there will be a continual testing of sentiment to retain or raise top marginal tax rates.
- The historical record does not support charges that the Federal tax system has become much less progressive and rewards the rich.
- The specific way the Tax Reform Act of 1986 (TRA-86) was crafted leaves an opening for top rate hikes, but, if rates are raised, they will have to reach down to at least the upper-middle income groups to realize significant revenues.
- Fiscal policy restraint and value-added taxation are viable alternatives to income tax increases.

Speaker Jim Wright (D-TX) is not likely to succeed in his proposal to extend the top personal tax rates of 1987 as a means of reducing the budget deficit. The commitment to the tax rate schedule under the Tax Reform Act of 1986 appears strong enough to allow the reduction from a top of 38-1/2 percent this year to basically 28 percent in 1988 to take place. That will not be the end of it, however. A good number of tax policy observers believe that the 28 percent rate is politically unstable. There will be continued testing of sentiment to reimpose higher personal rates in the future.

Obviously, the persistent, big budget deficit and the perceived need to grind away at it will keep all sorts of tax initiatives on the front burner in consideration of budgets for fiscal 1988, 1989, and 1990, anyway. In fiscal 1988, a combination of avowed spending restraint, government asset sales, increased fees, and selected new excises may get us through the year, perhaps in paper compliance with a less restrictive Gramm-Rudman-Hollings deficit reduction target. This would allow putting off more drastic action for another year.

We should never underestimate the resourcefulness of government to resort to new gimmickry. But the 1988 election should sharpen the focus again on national priorities and the way to finance them. And, despite the strong opposition of the current Administration, it's not too difficult to construct a scenario for higher, and more progressive,

income taxes. It goes like this:

On the Spending Side

- There is "no constituency" for restraining the growth of entitlements, especially Social Security; and defense spending increments cannot be cut back further without serious risk to national security.
- Non-defense, non-entitlement spending cannot be cut back significantly any more. In fact, there are building pressures to expand a number of Federal programs, such as aid to the homeless and state/local infrastructure improvements. (Witness the override of the President's veto on the highway bill.)
- A major new Federal program in health care could be very costly, even if means tested.
- Bailouts of the farm credit and thrift system also could be very expensive.

On the Tax Side

- The impact of TRA-86 is far from revenue neutral. Receipts lag well behind projections—although the specific blame for this undoubtedly could not be proven and apportioned, even after the fact.
- Continued economic growth—discounting a recession—produces revenue gains, but they are constrained by indexing of the personal tax structure.
- Post-TRA-86, there are still opportunities for base broadening in the income tax, but they are extremely difficult to implement. Furthermore, while big business bashing may be in vogue during the 1988 election, there is a realization that business "gave at the office" in TRA-86 and that further significant increases in corporate income taxes will jeopardize the economy.
- There is not enough political steam behind a value-added, or new broad-based, consumption tax.

What's left on the shelf? Jim Wright's approach is certainly up there. Freezing the top personal rate at 38-1/2 percent is alleged to net revenue gains of at least \$30 billion over three years, a nice start on the budget problem (on paper, anyway), according to its supporters.

There is another factor here that doesn't relate directly to the budget. There has been a spate of new studies on income and wealth distribution in the U.S. Most of them portray an increase in income inequality since the early post-war years. Census figures do show a slight increase in the percentage of household income received by the top fifth from 1959 to

Table 1
Household Income
Percent of Total Income Received

Year	Lowest Fifth	Top Fifth
1947	5.0	43.0
1959	4.9	41.1
1969	5.6	40.6
1979	5.2	41.7
1985	4.7	43.0

Source: Census Bureau, U.S. Department of Commerce

1985 and an even slighter drop in the amount received by the bottom fifth (see Table 1).

Interpretation of this type of data is in considerable dispute. There appears to be only very modest evidence that "the rich are getting richer and the poor, poorer." Yet, that is a widespread perception in media reports and seems to be taking hold in the legislative arena, as well. It is reinforced by continuing attacks on the 1981 tax cuts as "welfare for the rich."

A Brief History

It's true that the landmark 1981 tax bill (ERTA) did reduce the dollar tax burdens of upper-income taxpayers substantially, and because the principal thrust of it was an across-the-board proportional cut in rates, there was not much impact at the low end of the income scale. But ERTA should not be considered in isolation. It followed a series of post-war tax adjustments that gave relief mainly to the low and low-middle income groups. The 1978 act was an exception, but the main legislative thrust, particularly during the 1969-1977 period, was to redistribute income downward.

More important for actual results, as detailed in previous *Federal Tax Policy Memos*, was the interplay of inflation and graduated tax rates pushing people up the bracket ladder without necessarily accompanying increases in ability to pay. The net result was a markedly progressive individual tax structure pre-1981, which was eroded only slightly by ERTA. To quote tax analyst Joseph Minarik of the Urban Institute, "... People who dislike the effect of the 1981 tax cuts must recognize that the law it replaced was a post-1954 extreme, more progressive in its distribution of the tax burden... than any law of the preceding 25 years, reached as much through drift as conscious choice. Without the marginal rates over 50 percent, which were removed with general approval, no substitute for the 1981 tax cuts could perpetuate the progressivity of the 1981 tax law."

TRA-86 was more concerned with "horizontal" equity—equalizing tax burdens within income tax classes—than with the overall distribution. By raising exemptions and the standard deduction, it does reduce the share paid by the lowest income groups, and is estimated to knock some four million families off the rolls entirely in 1988 alone. (Some

of these are the same ones taken off the rolls by earlier actions, then recaptured through inflation.) Other than at the bottom, effective rates of tax among income groups changed only marginally, according to the Joint Committee on Taxation analysis shown below in Table 2. The structure was progressive before TRA-86 and a bit more progressive afterwards, despite the elimination of numerous graduated rates. It also can be argued that, because these taxes ultimately are borne more by owners of capital than by others, the Joint Committee distribution analysis understates the increase in progression under TRA-86.

In terms of actual liabilities, upper-income taxpayers as a group consistently have carried a very large burden, and, since ERTA in 1981, this burden has grown, despite the rate cuts. The Tax Foundation has provided an annual analysis of the share of Federal income taxes paid by adjusted gross income class. In 1984, the last year of record at this writing, the highest 5 percent of returns, with incomes of \$59,500 or more and an average tax liability of \$23,300, paid 38.2 percent of the total individual income tax—compared to a \$17,400 average tax payment and 37.6 percent share in 1979. Increases in tax liabilities of income groups over

Table 2
Average Income Tax Rate Under Prior Law
And the Tax Reform Act of 1986
By Income Class, 1988

Income Class (in thousands)	Average Income Tax Rate (percent)	
	Prior Law	TRA '86
\$ 0 - 10	1.6	0.5
10 - 20	5.7	4.4
20 - 30	8.3	7.5
30 - 40	9.5	8.7
40 - 50	11.1	10.1
50 - 75	13.3	13.1
75 - 100	15.7	15.6
100 - 200	19.3	18.9
200 and above	22.8	22.3
Total	11.8	11.1

Source: Joint Committee on Taxation

\$100,000 were particularly sharp, despite the cut in top marginal rates from 70 percent to 50 percent.

What about payroll taxes and state/local taxes? It's charged that these are mostly regressive, and the overall system is, therefore, much less progressive. That may be statistically true, but it is of uncertain implication for Federal tax policy. "Regressive" Social Security taxes support a "progressive" benefit structure for retirees. Under our Federal system, states and localities are free to design their own tax structures, and the distributional effects of these taxes are not subject to challenge at the Federal level.

It's interesting to note that, even with the growing burden of Social Security taxes combined with Federal income taxes, the Federal system remains progressive. Joseph Minarik's analysis of families subject to different tax laws over the last thirty years is shown in Table 3 below. (The analysis concerns one-earner families, and, admittedly, with two-earner families it probably would show a less progressive comparison.)

Whatever the reasons for any increase in income inequality in the U.S., Federal tax policy appears to have had little to do with it. If anything, policy has leaned in the other direction. This hardly means that tax policy is irrelevant to future social policy choices, but it does put it in a different perspective than many media reports.

Rate Hike Agenda

What if we do embark on a program to exact more

people. This year's 35 percent rate cuts in at \$45,000 of taxable income for joint returns and \$27,000 for single returns. That's why the commitment to the 1988 rate structure may be viewed as pretty strong among taxpayers well shy of fat-cat status.

Still, the specific way the reform legislation was crafted does leave an opening. In order to arrive at the designated distribution table and also to save revenue, Congress decided to phase out the benefit of both the 15 percent rate and the personal exemption, beginning in 1988. These decisions, in effect, created a third marginal rate of 33 percent applying to taxable income in excess of \$71,900 for joint returns and \$43,150 for single returns. The reach of the surcharge depends on the number of dependents claimed. A three-dependent, joint-return family would pay the 33 percent surcharge rate on income between \$71,900 and \$182,500 and

a flat rate of 28 percent on any income above that.

These income notches cause confusion and some planning difficulties for a lot of upper-income taxpayers. They also give the critics a free shot at the idea of the truly rich paying a lower rate than the near-rich. A cleaner way to have handled it would have been to change the personal exemption into a flat percentage credit applied across the board along with the intermediate tax rate. This may not have yielded the same

Table 3

Federal Tax Rates on Families at Multiples of the Median Income and Social Security Taxes Selected Years, 1954—1984

Federal Tax Law	Multiples of the Median Income						
	0.25	0.5	1	2	3	5	10
1954	2.00	2.00	7.82	12.87	15.37	18.96	28.37
1965	3.63	6.17	10.24	13.17	16.16	20.88	31.12
1975	-4.35	8.32	15.22	17.44	21.03	27.44	36.13
1980	-2.51	11.53	17.97	21.65	26.42	32.51	40.90
1984	2.03	13.03	17.29	20.62	23.61	27.90	34.22

Source: Joseph J. Minarik, *Making Tax Choices* (Washington, D.C.: The Urban Institute Press, 1985), p. 45. Copyright 1985 by the Urban Institute.

dollars from upper-income taxpayers? In the first place, to make any real difference in dollar terms, such a program also would have to hit the near-rich and probably those who only aspire to that status—in other words, getting down towards the middle class.

In the past, the Tax Foundation put out a regular report on how long we could run the government if it *confiscated* all income taxed at marginal rates higher than 50 percent. In 1980, it was eight days, based on a net to the Treasury of \$13 billion resulting from total confiscation of that income on 1.8 million returns, 2 percent of the returns filed. This particular exercise, of course, is no longer pertinent with the top rates down to 50 percent after 1981 and headed lower. But the point is still valid. There simply aren't enough of them to make a "soak-the-rich" campaign viable, as much as it might please dedicated income redistributors.

Of course, after TRA-86, theoretically we could raise significant money by jiggling the top rates well short of confiscation. But this would affect millions of middle-income

precise distribution table, but it would have done away with the notches. As it is, the structure invites a move to extend the 33 percent temporary rate to all income above the breakpoints.

Marginal Rates and Incentives

Behind the move to cut top marginal rates have been two policy objectives: to increase work and savings incentives and to improve the equity of the structure by discouraging tax shelter arrangements. The former has been stressed mainly by supply-siders; the latter, by tax reformers. When they came together, they exerted a powerful push on policy, as in early 1981, when the Democratic majority of the Ways and Means Committee jumped the gun on cutting the marginal rate from 70 percent to 50 percent in one swoop, when the Reagan Administration had proposed a more cautious, three-step phase-in of top rate reduction.

As indicated, tax receipts from the groups most affected by the marginal rate cuts have risen substantially. There's debate, however, over how much can be attributed to the tax

incentive effect on work effort, to increases in capital mobility and realizations because of the lower capital gains taxes, or simply to better overall economic performance after the 1981-82 recession. One thing the 1981 bill did not do was to discourage investment in tax shelters. Instead, these tended to blossom right through 1985.

It can be argued that the cut to a 50 percent top tax rate in 1981 was not a true test of the supply-siders' or reformists' objectives, in part because earned income was taxed at that rate previously. Now, with the prospect of a basic 28 percent rate, the outlook should be more promising. In fact, there is evidence that the combination of the lower tax rates and the crackdown on shelters has turned attention much more to economic income-producing, rather than tax-motivated, investments. This trend should continue.

The effect on savings is more problematic. The current personal savings rate is abysmally low. TRA-86 did away with some specific savings incentives, and, despite the drop in rates, its overall tilt, for the intermediate term anyway, is pro-consumption. Nevertheless, it can be argued with more authority that any *increase* in top rates on top of the base broadening under TRA-86 would have distinctly negative effects on personal savings and capital formation. So much so, in fact, that any serious move to impose higher marginal rates could rejuvenate interest in exempting savings, such as through the super-IRA proposal of Senator William V. Roth (R-DE), and to bringing back a partial exclusion of capital gains.

Ability to Pay

The "ability-to-pay" principle is deeply embedded in our system. There's not much argument whether it should apply. But the case for graduated and progressive rates to implement that principle has been an uneasy one. Supply-siders argue that high rates are simply counterproductive. Many tax reformers are troubled by the implications of high marginal rates as an invitation to special treatment, complexity, and non-compliance. And there was always the problem of arbitrary brackets and rates set not in relation to some grand plan for income redistribution but as after-effects of past events. Rates as high as 91 percent during the Korean War persisted for thirteen years afterwards. There was plenty of interest in reducing them but no agreement on how to rework the schedule until 1964.

One of the appeals of the flat tax movement is that it would render moot many of the questions about progression. A flat low percentage on a broad base is inherently attractive on that score. Unfortunately, it couldn't be designed without transferring a large tax burden from the top income groups

to the middle. Thus, we have the compromise in TRA-86 to liberalize low-income allowances and set two basic rates with the phase-outs of the first rate and the personal exemption. This somewhat imperfect compromise did preserve the "ability-to-pay" principle and progression of the structure without the overlay of twelve additional rates that applied in 1986.

If the new structure can be retained over time, it might well be a confidence building factor for all taxpayers. If they think the decision of the taxwriters as to basic rates will hold, they might well be less concerned with lost exclusions and deductions, less anxious to carve out new ones, and more willing to self-assess their liabilities in a forthright manner.

Other Scenarios

The looser spending control/tax increase scenario sketched earlier doesn't have to be. The proposition that we can grow out of the budget deficit is maligned these days, but it could just happen with some policy help. Mainly because of pullbacks in defense authorizations, the structural deficit outlook has brightened over the last year and a half. A serious effort to restrain the growth of entitlement outlays—which probably couldn't occur until after the 1988 elections—might offset the buildup of spending pressures elsewhere. If the next recession is very mild, tax receipts could stay in a rising trend despite all the changes under TRA-86.

What if we are not so lucky, and the deficits continue apace with the feared economic consequences? There are still alternatives to increasing income taxes. At the top of the list is a value-added tax. Most observers now agree that *if we are going to have* a broad-based consumption tax at the Federal level, the most acceptable form is value added. This would accommodate trade policy and minimize problems with the states. It is not necessarily "regressive" in impact. At the same time, it could gather big bucks, and this scares those concerned with limits on government. There isn't any good answer to this concern, except, of course, that the alternatives could be worse.

At present, there is no consensus on the need for a consumption tax. And one could not develop without some careful nurturing. A premature legislative thrust, such as occurred in 1978, could turn the body politic more firmly against it. Still, the coming elections could provide a forum for such development—probably not as a specific referendum on a consumption tax itself, but as a testing of the national will to control fiscal policy and maintain a lower profile of individual income tax rates.

(CREDIT, from page 2)

private investors, then charge the difference between the amount of the loans and the revenue from reselling them as a subsidy.

Sale of Loan Portfolio

The Administration and Congress have also embarked on a plan to sell old loans as a means of reducing the budget deficit. The government plans to sell about \$8 billion of loan assets in the 1987 fiscal year and \$11 billion in the 1988 fiscal year. Since it is holding \$250 billion in direct loans, the government could continue selling these loan assets for many years to come.

However, the sale of loans does not generate dollar-for-dollar deficit reduction. Inasmuch as most direct loans are subsidized, their market value is below their face value.

The Congressional Budget Office (CBO) has estimated that the \$11 billion of loan assets proposed for sale in fiscal 1988 would bring in slightly more than \$5 billion — less than 50 cents on the dollar.

Using Loans to Reduce Deficit

The use of loan assets to reduce the reported deficit is controversial. For one thing, the impact on financial markets is similar to additional government borrowing; for another, the sale of these assets can worsen future deficits, because the government foregoes the future interest and principal repayment of the loan assets it sells. CBO has suggested that loan asset sales be treated as means of financing the deficit, not counted as revenues.

Loan guarantees

The Federal government guarantees upwards of \$150 billion in loans each year, far more than it directly lends. In fact, the volume of guaranteed loans has soared in recent years while the amount of direct loans has declined. Unlike direct loans which, under current

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation

"Sobering Thoughts"

Cooperation, honesty, and courage. These are the traits the Tax Foundation's Shadow Committee on the Federal Budget recommends to Congress and the Administration as the deficit reduction debate goes forward. The very need to publicly affirm such basic staples of social intercourse gives food for thought.

Admittedly, neither the White House nor the Capitol are monasteries. Admittedly, Washington has no lock on shady dealings this season. Still, it is disheartening to contemplate a government whose ethical clutch seems to have slipped badly.

However, the Shadow Committee's recommendations are not mere moral posing or an attempt to assume some

kind of "holier-than-thou" stance.

They are a call to reaffirm once again the principles that have enabled this nation to work so well for more than two centuries: "We must all hang together, or we will most assuredly hang separately." "Honesty is the best policy." "Vote your conscience."

If the American people ever lose faith in their public institutions, it will be because they have concluded that the men and women who have been given the privilege to make those institutions work have betrayed their trust. The mockery that has become the annual budget process is inching dangerously close to that perception.

That's a sobering thought in this, the 200th year of our Constitution.

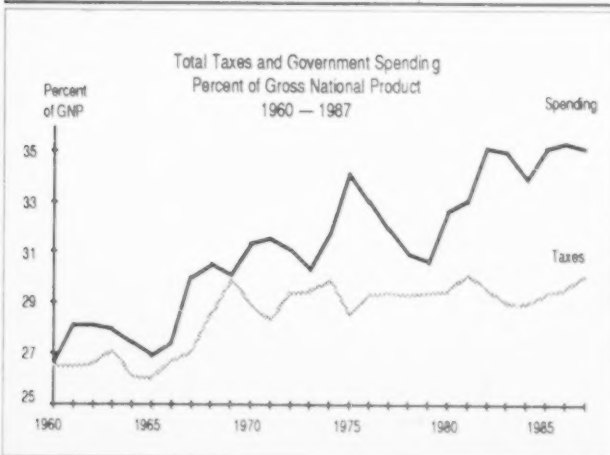
accounting practices, generate outlays and add to the deficit, guaranteed loans produce outlays only in case of default.

The growth in guarantees is partly due to financial pressures. When the budget is tight, the government has an incentive to provide assistance by means of guarantees which do not immediately raise outlays or the deficit. Nevertheless, loan guarantees have subsidy effects and influence capital markets. They allocate credit, favor some borrowers over others, and shift the risk from private lenders to taxpayers. OMB has estimated that loans guaranteed by the Federal government in fiscal 1986 had subsidies valued in excess of \$10 billion. With government experiencing default rates as high as 20 percent in ship financing programs and an estimated 10 percent in certain guaranteed farm loans, more than \$8 billion in guarantees were terminated for default in fiscal 1986.

When default occurs, the government has no effective control over the ensuing outlays. OMB has proposed to show the present value of the subsidy by purchasing commercial insurance for loans guaranteed by the government. The cost of the insurance would represent the value of the subsidy. In the short run, this insurance would add modestly to the budget deficit; but, presumably, it would lower long-term deficits by shifting the risk back to private insurers.

...

Direct and guaranteed loans are a legitimate means of providing assistance and they can be an efficient substitute for direct expenditures. But as long as their true cost is concealed in the budget, borrowers may be getting a free lunch for which the taxpayers have to pick up the bill.



"Wall Street Week" Features TF Data

On Friday, May 15th, the popular PBS television program, "Wall Street Week," made extensive use of Tax Foundation analyses of taxing and spending by all government. Host Louis Rukeyser used video charts similar to the graph at left to show that in 1987 total taxes have reached the 1981 peak level—over 30 percent of GNP—and that the Federal tax cuts under that year's Economic Recovery Tax Act (ERTA) had produced only a fleeting decline in total tax burdens.

Rukeyser also noted the continued rise in government spending as a percent of the overall economy, up two full percentage points since 1981. Total government spending will exceed 35 percent of GNP in 1987; this spending trend has clearly been the driving force to enlarge the government's share of the economy and the deficit as well.

(SALES TAX, from page 2)

No state general sales tax is levied in Alaska, Delaware, Montana, New Hampshire, or Oregon, although municipalities in Alaska do impose sales tax.

The state sales tax is lowest — 3 percent — in four states: Colorado, Georgia, North Carolina, and Wyoming. Localities in 29 states levy sales taxes, generally in addition to those shown in the accompanying table.

Individual Rates

Iowa (13 percent) and Connecticut and North Dakota (12 percent) have the highest marginal individual income tax rates. The rate schedules are progressive (i.e., rise as income brackets go up) in all but five states. Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania apply a flat rate, regardless of income level. In two states, income taxes are levied as a percentage of Federal individual income tax obligations — Rhode Island, and Vermont.

The maximum corporate income tax rates are highest in Iowa (12 percent); Connecticut (11.5 percent); Arizona and North Dakota (10.5 percent); and New York (10 percent).

Gasoline Tax

Gasoline taxes are highest in Montana (20 cents a gallon), Nebraska and Utah (19 cents) and Hawaii (where combined state-local rates range from 16 to 19 cents a gallon). The lowest rate — 4 cents — is levied in Florida, where gasoline is also subject to the general sales tax. The next lowest — 8 cents — applies in Alaska, New Jersey, New York, and Wyoming.

Cigarette Tax

Cigarette taxes also make a notable contribution to state tax revenues, Tax Foundation economists report. In fiscal 1986, the states collected \$4.4 billion, 2 percent of their total taxes, from tobacco products excises. Rates range from a high of 38 cents a pack in Minnesota to 2 cents in North Carolina.

The adjacent table gives further details, as of July 1, 1987, for major taxes and rates prevailing in the states.

Publications Available from TF

Memorandum on the Allocation of the Federal Tax Burden and Federal Grants-in-Aid by State, Fiscal Year 1986 (July 1987) \$4.00.

Federal Tax Burdens in State and Metropolitan Areas (1974). Describes methods used to derive above allocation formula. \$1.50.

Reports from the Shadow Committee on the Federal Budget: (\$2.00 for members, \$4.00 for non-members):
 Reducing the Deficit When Growth Slackens (May 1987)
 More Than Wishful Thinking Necessary to Reduce the Deficit (February 1987)
 The Misuse of Continuing Resolutions (October 1986)

*A Capital Budget for the Federal Government? (Working Paper - November 1986) \$2.00 for members; \$4.00 for non-members.

Please add \$1.00 for postage and handling.

Major Taxes and Rates Used by States, July 1, 1987

As Reported through June 2, 1987

State	Income Taxes		General Sales and Use Tax	Gasoline Tax (per gallon)	Cigarette Tax (per pack of 20)	Property Tax
	Corporation	Individual				
AL	5%(F)	2 to 5%(F)	4%(a)	11 cents	16.5 cents	X
AZ	2.5 to 10.5(F)	2 to 8(F)	5(a)	16	15	X
AR	1 to 6	1 to 7	4(a)	13.5	21	X
CA	9.6	1 to 11	4.75(a)	9	10	X
CO	5 to 5.5	3 to 8(F)	3(a)	18(b)	20	X
CT	11.5(c)	1 to 12(d)	7.5	17(e)	26	X
GA	6	1 to 6	3(a)	7.5 + 3% of retail	12	X
HI	5.85 to 6.435	2.25 to 11	4	16 to 19	40% wholesale	
ID	8	2 to 8.2	5	14.5	18	X
IL	4	2.5	5(a)	13	20	X
IN	3.4(f)	3.4	5	14	15.5	X
LA	6 to 12(F)	.5 to 13(F)	4(a)	16	26	
KS	4.5(g)	2 to 9(F)	4(a)	11	24	X
KY	3 to 7.25	2 to 6(F,n)	5(a)	15(i)	3.001	X
LA	4 to 8(F)	2 to 6(F)	4(a)	16	16	
ME	3.5 to 8.93	1 to 10	5	14	28	X
MD	7	2 to 5	5	18.5(i)	13	X
MA	8.33(j)	5(k)	5	11	26	X
MI	2.35	4.6	4	15	21	X
MN	9.5	4 to 9(p)	6(a)	17	38	X
MS	3 to 5	3 to 5	6	15(e)	18	X
MO	5(F)	1.5 to 6(F)	4.225(a,b)	11	13	X
NE	4.75 to 6.65	2 to 5.9	4(a)	19	27	X
NJ	9(l)	2 to 3.5	6	8	25	X
NM	4.8 to 7.6	1.8 to 8.5(m)	4.75(a)	14	15	X
NY	10(c)	2 to 8.75(b)	4(a)	8	21	
NC	6	3 to 7	3(a)	15.5	2	X
ND	3 to 10.5(F)	2.67 to 12(F,n,o)	5.5(b)	17	27	X
OH	5.1 to 9.2(c)	.751 to 6.9(b)	5(a)	12	14	X
OK	5	.5 to 6(F,m)	4(a)	16	23	
PA	8.5	2.1	6	12	18	X
RJ	8(c)	23.96% of Federal income tax	6	13(i)	25	X
SC	6	2 to 7	5	13	7	X
TN	6	6(d)	5.5(a)	17	13	
UT	5	2.25 to 7.75(F)	5.094(a,b)	19	23	X
VT	6 to 9(b)	25.8% of Federal income tax	4(b)	13	17	X
VA	6	2 to 5.75	3.5(a)	17.5	2.5	X
WV	9.75(b)	3 to 6.5	5	10.5	17	X
WI	7.9	5 to 7.9	5(a)	18	25	X
FL	5.5		5(a)	4	24	X
NV	These 5 states have no corporate income tax	These 7 states have no individual income tax	5.75(a)	11.25	15	X
SD			5(a,h)	13	23	
TX			5.25(a,b)	15(b)	20.5	
WA			6.5(a)	18	31	X
WY			3(a)	8	8	X
AK	1 to 9.4			8	16	X
DE	8.7	1 to 8.8(F,h)	5 states	13	14	
MT	6.75(e,m)	2 to 11(F)	have no general sales tax	20	16	X
NH	8	5(d)		14	17	X
OR	6.6	5 to 9(F,h)		12	27	X

(X) Indicates state levies a property tax.

(F) Allows Federal income tax as a deduction.

(a) Local taxes are additional.

(b) Future reduction scheduled under current law.

(c) Alternative methods of calculation may be required.

(d) In Connecticut, New Hampshire, and Tennessee, tax applies to income from intangibles only, at various rates according to type. In Connecticut, capital gains are taxed at 7%.

(e) Future increases scheduled under current law.

(f) Tax is 3.4% of adjusted gross income. A supplemental net income tax is imposed at 4.5%.

(g) A 2-1/4% surtax is imposed on taxable income in excess of \$25,000.

(h) Deductions limited.

(i) Tax imposed at percent of wholesale value.

(j) Additional 14% surtax is imposed.

(k) Tax of 10% on income derived from intangibles, and 5% on all other income.

(l) Additional tax on net worth is part of the corporate franchise tax.

(m) Qualified taxpayers may elect to pay alternative taxes at varying rates.

(n) Optional tax of 14% of taxpayer's adjusted Federal income tax liability.

(o) Additional 10% surtax is imposed for 1987.

(p) Plus 10% of Federal tax paid under Sec. 1(g) of Internal Revenue Code.

Source: Compiled by Tax Foundation from data reported by Commerce Clearing House.

TAX·FEATURES

Recent Gains in Disposable Income Fail To Offset Long-Term Erosion by Taxes, Inflation

Shadow Committee Addresses Current Stalemate over Budget

Tax Foundation's Shadow Committee on the Federal Budget states in a newly released report that Congress and the President must avert a new upward spiral in deficits by agreeing "on a package of spending cutbacks and revenue increases that lowers the deficit, not only in the fiscal 1988 year, but for several years ahead."

In revising the Gramm-Rudman-Hollings process, the Congress should keep in mind that "the key to responsible deficit reduction is to use targets that ensure that each year's deficit is lower as a percentage of the Gross National Product and also lower than the previous year's deficit level."

The full report is available from the Tax Foundation at a cost of \$4.00 plus \$1.00 postage/handling.

Total Government Spending Soars, Doubles in 8 Years to \$1.76 Trillion

Spending by all government units in the United States has more than doubled since 1979 and will reach an estimated \$1.76 trillion in fiscal year 1987, according to Tax Foundation analysts.

The country will accordingly witness its seventh year of trillion-dollar government budgets. (Some may recall that the nation's total output of goods and services - public and private - did not reach the trillion-dollar level until 1970.)

This year's spending by Federal, state, and local jurisdictions will amount to \$7,271 per capita, up from \$3,726 in 1979. Per household, that comes to \$19,660 for each of the nation's 89 million households, as compared to \$10,764 eight years ago.

The growth rate of government spending since 1979 has far outpaced the growth in the nation's total output, or gross national product (GNP).

Public spending, measured on a calendar year basis and within the framework of the national income and product accounts, increased at a rate one-third higher than concurrent growth in GNP. In 1979 government spending accounted for less than 31 percent of GNP; in 1987 government's share is more

(Continued on page 4)

Slowing of inflation and Federal tax cuts have boosted the U.S. family's purchasing power since 1981, according to Tax Foundation analysts. Despite these gains, the prototypical family - one earner who is married with two dependent children and is employed full-time year round earning \$28,230 before taxes - is worse off today than it was ten years ago, with \$2,010 less purchasing power.

Measured in constant 1987 dollars, the family's real income after direct Federal taxes has increased by \$1,242 (5.6 percent) since 1981. This contrasts dramatically with the preceding four years, when the family's purchasing power dropped \$3,252 in 1987 dollars.

Between 1977 and 1981, inflation and rising Federal taxes eroded nearly 13 percent from the buying power of this prototypical family. This period saw increases in Federal income and social security taxes on this family average more than 11 percent annually, while inflation rose at a rate of nearly 11 percent a year. Even though the family's nominal income grew by nearly 8 percent annually, higher increases in taxes and inflation cut deep into real purchasing power.

In sharp contrast, Federal direct taxes between 1981 and 1987 have risen just over 4 percent annually, and inflation has slowed to an average of less than 4

(Continued on page 5)

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INSERT:
Capital Gains
Tax

Median Family Income Before and After Direct Federal Taxes and Inflation, 1977 - 1987

Year	Median Family Income ^a	Direct Federal Taxes			After-tax Income	
		Income Tax ^b	Social Security	Total	Current Dollars	1987 Dollars ^c
1977	15,949	1,466	933	2,399	13,550	25,518
1978	17,318	1,717	1,048	2,765	14,553	25,442
1979	19,048	1,881	1,168	3,049	15,999	25,116
1980	20,586	2,143	1,262	3,405	17,181	23,763
1981	21,462	2,267	1,427	3,694	17,768	22,266
1982	23,036	2,342	1,543	3,885	19,151	22,610
1983	23,943	2,277	1,604	3,881	20,062	22,954
1984	25,415	2,395	1,703	4,098	21,317	23,374
1985	25,992	2,466	1,832	4,298	21,694	23,005
1986 ^d	27,144	2,865	1,941	4,806	22,338	23,220
1987 ^d	28,230	2,704	2,018	4,722	23,508	23,508

^a Median income for all families with one earner employed full-time, year-round.

^b Married couple filing joint return, two dependent children.

^c Adjusted by Consumer Price Index of the Bureau of Labor Statistics. Assumes 4% inflation in 1987.

^d Estimated by Tax Foundation.

Sources: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; Treasury Department, Internal Revenue Service.

How Federal, State, and Local Governments Raise All that Money . . .

Individual income taxes were the largest single source of revenue for U.S. governments in 1985 (latest reported), accounting for 28.3 cents of every dollar raised by Federal, state, and local governments, according to Tax Foundation economists.

More than \$401 billion of the \$1.418 trillion that governments collected in 1985 came from individual income taxes.

Social security payroll taxes were the second major revenue source, raising 16.7 cents of every revenue dollar, or nearly \$237 billion in 1985. Following were current charges, 9.6 cents; miscellaneous general revenue (e.g., interest earnings and sales of government property), 7.8 cents; property taxes levied by state and local governments, 7.3 cents; selective sales and excise taxes, 6.4 cents; general sales taxes, 5.9 cents; corporate income taxes, 5.7 cents; and miscellaneous taxes (death and gift, motor vehicle and operators' licenses, unemployment compensation, and others, 4.6 cents per dollar of total revenue.

Individual income taxes have held the top position as a revenue producer since World War II. In 1985 they provided just slightly more of the revenue dollar than they had 25 years earlier, 28.3 cents compared with 28.2 cents in 1960. Their share of the total, however, is down slightly from 30.3 cents in 1970 and 30.7 cents in 1980. The relative decline in the role of individual income taxes reflects two main factors, according to Tax Foundation analysts. One is

(Continued on page 6)

How Federal, State, and Local Governments Raise Each Dollar of Public Funds Selected Fiscal Years 1960-1985

Source	Cents per dollar of total revenue			
	1960	1970	1980	1985
Tax revenues	82.7	82.4	78.2	74.9
Individual income	28.2	30.3	30.7	28.3
Social Security (OASDHI)	7.0	11.5	15.0	16.7
Property	10.7	10.2	7.3	7.3
Selective sales and excises	12.5	9.8	6.5	6.4
Corporate income	14.8	11.0	8.4	5.7
General sales	3.5	4.8	5.5	5.9
Other taxes (a)	6.0	4.8	4.8	4.6
Nontax revenues	17.3	17.6	21.8	25.1
Current charges	8.1	7.9	8.6	9.6
Miscellaneous general revenue(b)	3.3	4.0	6.7	7.8
Employee retirement	1.9	2.5	3.1	4.1
Utilities and liquor stores	3.2	2.6	2.7	3.1
Other nontaxes	.8	.6	.7	.5

Exhibit (billions):

Total revenues	\$153.1	\$333.8	\$932.2	\$1,418.4
Surplus (+) or deficit (-)	-\$1.8	+\$8	-\$26.5	-\$162.7

(a) Includes death and gift, motor vehicle and operators' licenses, unemployment compensation, and miscellaneous taxes.

(b) Includes interest earnings, special assessments, sale of property, and others.
Sources: *Facts and Figures on Government Finance*, 1986, Tax Foundation; and other data from U.S. Department of Commerce, Bureau of the Census.

. . . . And How They Spend It All

How Federal, State, and Local Governments Spend Each Dollar of Public Funds Selected Fiscal Years 1960-1985

Function	Cents per dollar of total spending			
	1960	1970	1980	1985
Major social welfare programs, total	20.6	25.8	33.6	31.9
Social Security (OASDHI)	7.1	10.8	15.6	16.0
Social services and income maintenance (a)	8.5	10.7	13.0	11.4
Government employee retirement	1.4	1.9	3.0	3.0
Veterans (not elsewhere classified)	2.5	1.6	1.3	1.1
Railroad retirement	.6	.5	.5	.4
National defense and international relations	32.3	25.3	15.6	18.3
Education	12.8	16.7	15.0	13.0
Interest on general debt	6.2	5.5	7.9	10.9
Environment and housing	5.4	4.4	4.9	5.7
Utilities and liquor stores	3.4	2.8	3.8	3.8
Transportation	7.6	6.2	4.4	3.6
Public safety	1.8	2.0	2.3	3.2
Government administration	1.8	1.9	2.2	2.3
Postal service (Federal)	2.5	2.3	1.9	1.8
Sanitation	1.1	1.0	1.4	1.1
All other	4.5	6.1	7.0	4.4

Exhibit (billions):

Total spending	\$151.3	\$333.0	\$958.7	\$1,581.1
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(a) Comprises public welfare, hospitals, health, and unemployment insurance benefits.
Sources: *Facts and Figures on Government Finance*, 1986, Tax Foundation; and other data from U.S. Department of Commerce, Bureau of the Census.

Social welfare programs consumed 31.9 cents of every government dollar spent in 1985 (latest reported). Nearly one-third of all 1985 public expenditures, some \$504 billion out of total spending by all levels of government of \$1,581 billion, went to support the social welfare network.

National defense and international relations was the second highest at 18.3 cents per dollar. Education expenditures ranked third, taking 13.0 cents per dollar; interest costs ranked fourth at 10.9 cents; and environment and housing followed at 5.7 cents.

Federal social security (OASDHI) led the field, claiming 16.0 cents of every dollar spent by all levels of government. Social welfare programs also include social services and income

maintenance (public welfare, health and hospitals, and unemployment insurance), which accounted for 11.4 cents per dollar of government spending. Other programs included are government employee retirement, railroad retirement, and veterans' programs not elsewhere classified—4.5 cents.

Even these large

(Continued on page 6)

Tax Features

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A Decade of Deficits; Generations of Debt

When the budgetary history of the 1980s is written, two words—deficits and debt—will sum up the failure of the federal government to manage the nation's finances in a responsible manner. This has been a decade of record deficits and of a truly massive escalation in the public debt of the United States. The budget deficit has exceeded \$100 billion in every fiscal year since 1982; it has been about \$200 billion in three of the past four fiscal years. This tide of red ink has left the federal government owing more than ever before. When the decade started, the public debt was less than one trillion dollars; when it ends, the debt will be more than three trillion

When the budgetary history of the 1980s is written, two words—deficits and debt—will sum up the failure of the federal government to manage the nation's finances in a responsible manner.

dollars. Each American's "share" of the public debt is about \$10,000—more than two thirds of per capita income.

How did we get into this mess? What does it portend for the future financial health of the United States? Can anything be done about it? At this stage, it is easier to explain what went awry than to devise acceptable solutions; nevertheless, steps can be taken to prevent matters from getting much worse.

Why We Borrowed So Much

Looking back at recent deficits, there is enough blame to go around. The President persuaded Congress to cut income tax rates at the same time he was campaigning for more defense spending. Congress slowed the growth in domestic expenditures, but it did little to control the steep rise in transfer payments and other entitlements. For the past five years, the White House and Congress have been locked in a

budgetary stalemate which has impeded deficit reduction. The Gramm-Rudman-Hollings (GRH) process has helped a bit, but much less than promised. In the 1986-88 period, actual deficits will total more than \$100 billion above the GRH targets. Both branches have used accounting tricks to make the deficit appear lower than it actually is. By substituting for real savings, these gimmicks have allowed the public debt to continue its upward spiral.

Economic conditions, interest costs, and the way in which the debt is financed have also contributed to the explosion of debt.

Weak economic growth. The economy has been growing about 2 percent a year in the 1980s, only about half the growth rate in the 1950s and 1960s and below the growth in the troubled 1970s. Growth in this decade has generally been below the level assumed in the budget; as a consequence, deficits have been above budgeted levels. In effect, the Federal government is spending as if the economy were producing 4 percent real growth a year.

Interest payments. Deficits beget deficits, as each year's added borrowing burdens the government with more interest to pay. Net interest has soared from \$52 billion in 1980 to about \$140 billion in the current fiscal year. One out of every seven dollars in the budget now goes to pay interest on the public debt. If it were free of these interest charges, the budget would almost be balanced.

Financing the debt. The government finances a sizeable portion of the deficit by

The Gramm-Rudman-Hollings (GRH) process has helped a bit, but much less than promised. In the 1986-88 period, actual deficits will total more than \$100 billion above the GRH target.

borrowing from the social security fund and other trust funds. If these trust funds were excluded, the actual deficit would be tens of billions of dollars above the amount

reported in the unified budget. One consequence of this financing method is that the debt increase is greater than the deficit. During the 1980s, the increase in the debt is likely to be about \$500 billion more than the decade's cumulative budget deficit.

One out of every seven dollars in the budget now goes to pay interest on the public debt. If it were free of these interest charges, the budget would almost be balanced.

Why the Size of the Debt Matters

It has become fashionable in recent years to downplay the size of the public debt. A 1986 book by economist Robert Eisner, *How Real is the Federal Deficit?*, argues that the debt would be a lot smaller if adjustments were made for inflation and changes in the government's capital assets. Unfortunately, however, capital markets deal with actual numbers, not with arbitrary adjustments. Moreover, the steepest rise in the debt has occurred during a period of declining inflation.

To understand the dangers latent in the government's huge debt, it is essential to keep in mind that, unlike states and localities which actually pay off maturing debt, the Federal government almost always rolls over its indebtedness. There are two critical implications of this practice: (1) Every additional billion dollars borrowed in 1987 will mean additional billions of dollars of debt down the road. Over a long span the government will pay many billions of dollars in interest charges for each additional billion dollars of debt. (2) If there are adverse market conditions and high interest rates when the government borrows, these affect not only the new funds it seeks to raise but the refinancing of old debt as well.

The following are a number of other problems associated with the massive debt.

(Continued on page 4)

(DECADE OF DEFICITS, from page 3)

The ratio of debt to GNP. As long as the economy is growing fast, some rise in the debt may not indicate financial difficulty. The table at right shows that the ratio of debt to GNP fell steadily from 96% in 1950 to only 34% in 1980. Since then, however, this ratio has soared more than 20 percentage points. In 1980, each dollar of debt was backed by three dollars of gross national product; today, it is supported by less than two dollars of GNP. While the debt/GNP ratio is still well below early postwar levels, the recent indebtedness has been incurred in peacetime.

Foreign indebtedness. As the debt has grown, so too has the amount borrowed abroad. The amount of public debt held by foreigners has soared from \$122 billion in 1980 to \$256 billion in 1986. In 1986 alone, the Federal Government borrowed almost \$50 billion from foreign residents. Private borrowing abroad has also increased sharply. This dependence on foreign lenders adversely affects Americans in two ways: first, interest on foreign-held debt represents the transfer of wealth from the United States to other countries; second, the government is increasingly dependent on the willingness of foreigners to lend us money. When Japanese participation in Treasury financing slackened earlier this year, interest rates soared.

Rigid budgets. Rising interest charges have contributed to increased rigidity in Federal expenditures. These charges and mandatory entitlements now account for close to two-thirds of total Federal spend-

ing. There can be little doubt that the interest burden has impeded the government's capacity to respond to changing priorities.

Easing the Debt Crisis

Recent economic performance demonstrates that the Federal government cannot grow out of big deficits. The country is now in the fifth consecutive year of economic expansion, but the 1987 deficit will probably be \$50 billion above the level in

possibility of a recession in the not-too-distant future cannot be dismissed. If the economy slips, the deficit and debt will be propelled upward. One of the lessons of the 1980s is that one year's cyclical deficit rapidly becomes the next year's structural deficit. Care must be taken, therefore, to control the deficit before the economy turns sluggish.

The problem could be aggravated in the longer term due to the fact mentioned earlier that much of the debt is financed by borrowing from social security and other funds. As the social security trust fund builds up gargantuan surpluses—exceeding one trillion dollars by the end of the century—the Federal government will have a convenient source of “in-house” borrowed funds. But when the balances in the social security fund are drawn down in the 21st century to pay retirement benefits to the baby boomers, the overall annual deficit might greatly surpass

Federal Debt and Interest Payments Selected Fiscal Years, 1950-1990 (\$ billions)

Year	Debt*		Deficit	Net Interest	
	Total	% GNP		Total	% Outlays
1950	\$ 256.9	96.3%	\$ 3.1	\$ 4.8	11.3%
1960	290.9	57.4	+0.3	6.9	7.5
1970	382.6	38.6	2.8	14.4	7.4
1980	914.3	34.2	73.8	52.5	8.9
1985	1,827.4	46.4	212.3	129.4	13.7
1987**	2,372.4	53.7	173.2	137.5	13.5
1988**	2,585.5	55.1	107.8	139.0	13.6
1990**	2,991.3		59.5		

* End of fiscal year

** Office of Management and Budget projections

1982, the last recession year.

Controlling the deficit is the key to stabilizing the debt burden. It requires both short-term and long-term actions. The immediate need is to lower the debt/GNP ratio and the percentage of outlays allocated to interest payments. The deficit-reduction path laid out by the Gramm-Rudman-Hollings law would accomplish this objective, but the GRH targets have not been met thus far, and it is doubtful whether they can be met in the years ahead without significant changes in budget policies.

With the recovery in its fifth year, the

anything experienced thus far. If we wait until that happens, it will be too late to take corrective action. One way of preparing for this problem is to establish GRH-type targets for the “Federal funds” deficit, that is, to exclude social security and (possibly) other trust funds from each year's required deficit reduction.

The decade of deficits and debt is nearing an end, but its legacy will be borne by many generations to come. Now is the time to control the damage; if we don't, a poorer country will pay a frightful price for our failures.

Federal, State, and Local Government Expenditures* Selected Fiscal Years 1950-1987

Fiscal year	Billions of dollars			Dollars	
	All gov'ts	Federal	State and local	Per household	Per capita
1950	\$ 70.3	\$ 44.8	\$ 25.5	\$ 1,614	\$ 466
1960	151.3	97.3	54.0	2,866	847
1965	205.7	130.1	75.6	3,581	1,067
1970	333.0	208.2	124.8	5,252	1,643
1975	560.1	340.5	219.6	7,875	2,612
1980	958.6	615.4	343.2	11,867	4,243
1981	1,109.8	717.4	392.4	13,474	4,857
1982	1,233.5	794.7	438.8	14,768	5,345
1983	1,351.0	872.5	478.5	16,099	5,798
1984	1,428.0	926.5	501.6	16,720	6,056
1985	1,581.1	1,030.2	550.9	18,217	6,644
1986 ^b	1,675.6	1,077.5	597.7	18,943	6,972
1987 ^a	1,763.5	1,106.0	657.5	19,660	7,271

^a Grants-in-aid are counted as expenditures of the first disbursing unit.

^b Estimated by Tax Foundation.

Sources: Basic data from U.S. Department of Commerce, Bureau of the Census; computations by Tax Foundation.

(TOTAL GOVERNMENT SPENDING, from page 1)

than 35 percent of total GNP. Expressed in other terms the increase in public spending since 1979 is equal to nearly 41 percent of the increase in overall GNP in the past eight years.

But in the last two years, Tax Foundation analysts say, the growth of government has been slowing. Spending is expected to rise by an annual average of under 6 percent in the years 1985-1987, as compared to average yearly increases of 10.5 percent in the first half of the 1980s and 11.1 percent during the 1970s. In fiscal 1987 alone, public spending will rise by an estimated \$88 billion, or 5.2 percent—a modest percentage gain by recent standards. The slowing reflects restraints in the growth of Federal outlays, attributable largely to the efforts of Congress and the Administration to pare bulging Federal budget deficits.

Tax Foundation economists estimate that Federal spending will go up by just 2.6 percent in 1987, the smallest annual increase in more than a decade. In contrast, between 1980 and 1985, Federal spending grew by 10.0 percent a

(Continued on page 5)

FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

JULY/AUGUST 1987

Capital Gains Taxation: '86 Changes Are 'Anti-People'

By C. Lowell Harriss

The capital gains provisions of the Tax Reform Act of 1986 (TRA '86) are "anti-people" in the sense that they seek to transfer personal capital to government—mainly for consumption rather than investment. And consuming capital reduces the base for production of goods for the public. TRA '86 also cuts the after-tax rewards for the risk-taking that contributes to human progress.

Major Change

The new rule is that realized capital gains will be taxed in full as ordinary income. Losses will be deductible against realized gains but still not against ordinary income in excess of \$3,000. Other provisions curtail or eliminate various arrangements, sometimes rather artificial, that were used to convert ordinary income into capital gains for tax purposes.

The new treatment of capital gains will have many complex and unexpected effects. One thing is quite certain, however. The effective tax rate that now applies will generally be 28 percent, as against an average rate in the recent past which was well below the maximum rate of 20 percent. Add on state taxes, and, for many, the overall tax on capital gains now will approach one third, often more than doubling the total burden.

Such an outcome contradicts the promise of lower rates and fairer tax burdens which drove the tax reform movement in its early stages.

Consuming Capital

Capital has a crucial rule in human progress. One should think of a unit of capital, if maintained, as adding permanently to the flow of production and income. This truth, the productive worth of capital, has been established over a long history. The beneficiaries of investment are people—in our capacities as workers, consumers, and investors. Capital is one part of the cooperative process of production for everyone, not something benefiting only the already prosperous or something to be set off as a rival to labor.

Per dollar of revenue, a tax on capital gains ranks at, or near, the top in adverse effects on capital formation and preservation. While the tax does not destroy existing machinery or utility systems or housing, it does take funds from taxpayers who thereby suffer loss of ability to finance the maintenance and improvement of the nation's capital base.

Lawmakers and the staff advisors who guided many of their

policies expected the capital gains provisions of TRA '86 to increase government revenue. In effect, they planned for government to take some private capital holdings to pay for the government's current spending. Even as responsible leaders were correctly deploring the low rate of *net saving* in the United States, the framers of tax revision explicitly designed a capital *consumption* element into last year's "reform."

Quite possibly, however, there will be no net revenue gain. The higher tax rate actually may be a revenue loser. The rate increase will discourage the realizing of gains. With Federal plus state taxes absorbing one-third or so of a gain, an owner can reinvest only two-thirds of the gain. In the past he would have had more than three-fourths (usually much more) to reinvest. The added burden will in many cases tip the balance against realizing gain and paying any tax.

Tightening the Lock-In

When a property owner chooses not to realize gains because of the potential tax on the transaction, there is a "lock-in" effect. The investor will hold assets with accrued gains longer than indicated by investment criteria alone.

The production of an economy and its progress depend not only upon the total quantity of labor, capital and natural resources, but also upon the allocation of what is available. Some uses of capacity are more productive than others. The more promptly and easily resources move from the lesser to the better use—i.e., the smoother the process of allocation—the greater the productivity of the economy. The benefits spread broadly—to employees, owners of land and other natural resources, suppliers of capital, and consumers.

Unquestionably, TRA '86 increased the incentive to retain assets with gains. Holding capital involves no tax, while selling to reinvest will cost more than in the past. The accentuated bias against the redeployment of capital creates "excess burden." The economy loses through poorer resource allocation, and there is no comparable revenue growth for the Treasury. This lock-in could be reduced by extending to all capital transactions the tax-free rollover treatment now allowed for certain sales of homes. A government plagued with large deficits, however, will tend to resist changes that are perceived as reducing immediate revenue.

The Blow to Risk-Taking

The capital gains provisions of TRA '86 strike at risk-taking, a crucial element in economic progress. Some progress comes from doing more of the same, for example, construction of new housing. Much advance, however, comes from inno-

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vation, from doing the untested. Most of us know too little of history to appreciate the pioneering and venturing into the unknown, the imagination and the effort, the risking of funds and the heartbreak, all the many forms of risk that have contributed to our life. What we now take for granted was once one person's "gleam in the eye," scoffed at and ignored by others.

Persons who were successful in risky ventures—those who invested ideas and effort and those who put up the funds—could escape the full bite of income taxation. Capital gains were not taxed until realized and then at rates below those on ordinary income. Although tax offsets for losses were incomplete, persons taking risks could expect some protection from the top rates of income taxation. If successful, they could press ahead, using earnings to finance some expansion. Moreover, there was valid hope of keeping most of the gain if they sold and of passing much to heirs even after death taxes.

Recent reductions in high-bracket tax rates resulted in part from the belief that the freeing of human creativity will bring benefits to all Americans. More persons of talent and ambition, it was argued, will make greater efforts to develop new products and services and to provide expanded and more efficient production facilities. Lowering tax rates increase the rewards for successful innovation and entrepreneurship. The general public benefits. Over the years, risk-taking will be greater if after-tax rewards are more attractive.

But although personal tax rates will now be lower than at any time within the memory of most Americans, the taxes on successful venturing will be heavier. While reducing burdens on the rewards for routine work and on the fruits of conservative investment—on ordinary income—the new law increases the burdens on realized gains from successful risk-taking.

Just as TRA '86's lock-in effect will tend to reduce, not increase, revenue, so also any discouraging of entrepreneurship and innovation will tend to dampen economic growth. Over the years, the growth of the country's economic base, and of the Treasury's revenues, will be slower. As a portion of the overall economy, this factor may not be large. But any diminished potential for growth justifies concern, particularly when the loss is avoidable.

In 1978, Congress reversed course and cut the tax rate on capital gains. In doing so, it not only moderated the tax bite but also gave evidence of a new spirit, one more hospitable to business enterprise. A marked rise in the supply of venture capital followed. While the extent of causal influence cannot be precisely measured, the change was dramatic. The record is consistent with a conclusion that reducing the tax on successful risk-taking will increase the supply. TRA '86 will not choke off risk-taking, but it will discourage this vital economic tonic.

Fairness Issues

Fairness and equity considerations raise complex issues in considering the taxation of capital gains and losses. For ex-

ample, lucky winnings from stock or real estate investments must constitute taxpaying capacity. Any exemptions of gains from luck alone, or taxation at rates lower than those on the ordinary income of middle-class workers and investors, must seem inequitable. So will a system that imposes tax on a person who has true capital losses that are greater than his ordinary income. The enormous variety in the differences in personal economic positions complicates the search for fairness in taxation. The taxpayer has some control over realizing gains and losses, and thus has some ability to influence the tax due.

Not everything qualifying as a capital gain in recent years has resulted from innovative, successful, creative entrepreneurship. Not all of the tax-saving devices served the economy well, certainly not well enough to deserve effective tax rates that were lower than those paid by the working person or the thrifty family on its savings account. To avoid heavy, discouraging tax burdens on risk-taking in creative enterprise, a society need not offer relatively easy ways to convert ordinary income into capital gains.

TRA '86 does reduce the differences in effective tax rates on incomes of different sizes. Provisions altering the tax structure, e.g., those affecting use of tax shelters, profoundly change the application of income taxation. Do the net results, including those from the new treatment of capital gains and losses, enhance or erode the equity of sharing the cost of government?

There are no clear guides to resolve debates on fairness. On a few points, however, there may be some agreement. There will probably be wide consensus that limiting the deduction of losses to capital gains and \$3,000 of ordinary income a year creates unfairness. It is simply not fair to impose income tax when a person has losses greater than ordinary income. Why has this long-recognized inequity not been corrected? One reason is the desire for revenue. A second reason grows out of the taxpayer's control over realization. It is sensible to delay the realization of gains and take advantage of deductibility of losses. However, the \$3,000 a year limit certainly could be increased without enabling persons with large incomes to escape all income tax.

On another point, there will also be widespread agreement. The present system is inequitable in failing to allow for inflation. The full dollar amount of a gain is taxed regardless of what has happened to the worth of the dollar while the asset was held. The owner may have had no real income, or the amount realized net of inflation may be appreciably less than the dollar figure. The dollar has lost much purchasing power in the last fifteen years. Would not everyone agree that it is unfair to tax as income a change in capital value that merely equals, or may even fall short of, the decline in the worth of the dollar?

* * * *

Substantive change of TRA '86 will come despite dislike for the thought of another round of major revision. When there is opportunity, an outstanding candidate for change to reduce obstacles to economic progress will be in the taxation of capital gains and losses.

(FAMILY PURCHASING POWER, from page 1) percent a year. These developments have increased the family's purchasing power an average of .9 percent a year for the six years, even though the family's nominal income increases fell from an average of 8 percent to less than 5 percent annually. While social security taxes far outpaced nominal income growth because of increases in tax rates, Federal income taxes rose at a slower rate (3 percent a year on average) and inflation was somewhat below the rise in nominal income.

This modest improvement has not made up for what was lost during earlier years of the decade. From 1977 to 1987, while pre-tax nominal income rose 77 percent, direct Federal taxes increased by nearly 97 percent, from \$2,399 to \$4,722. Income taxes rose from \$1,466 in 1977 to \$2,704 in 1987, an increase of 84%. Social security taxes more than doubled, rising from \$933 to \$2,018.

Despite two major income tax reduction laws — in 1981 and 1986 — Federal personal income taxes as a share of the family's nominal income rose from 9.2 percent in 1977 to 9.6 percent in 1987. Social security taxes went up even more rapidly, from 5.85 percent of income ten years ago to 7.15 percent in 1987. This year, direct Federal taxes will claim 16.7 percent of the family's income, more than the 15.0 percent that prevailed at the beginning of the decade. The peak in taxes for the decade — 17.2 percent — occurred in 1981.

While taxes had a role in reducing the purchasing power of the family, the real culprit was inflation. For the period 1977 through 1987 the price level, as measured by the Consumer Price Index, rose more than 88 percent, making each 1977 dollar worth only 53 cents in 1987. The combination of rising prices and a growing tax bite reduced the purchasing power of the family by nearly 8 percent for the decade.

(TOTAL GOV'T SPENDING, from page 4)

year on average. State and local spending is expected to continue to rise at a rate of around 10 percent, similar to that experienced during the first half of the decade.

The Federal government's \$1.11 trillion share of public spending in 1987 accounts for about 63 percent of the total, slightly less than in recent years, and down from 65 percent in 1985. This has not always been the case, however. Tax Foundation researchers note that Federal spending was less than 50 percent of total public spending until the mid-1930s. World War II developments catapulted that share to over 90 percent during the peak spending years.

States and localities will spend an estimated \$658 billion this year from the funds they raise. (Expenditures from Federal grants-in-aid to these units are counted in the Federal total.) This will represent an increase of about \$60 billion over the previous fiscal year, as compared to the estimated \$28 billion rise in Federal outlays.

THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

"... And Promises to Keep"

The air of the Capital City is electric with allegations of betrayed trust this summer. As the Iran/Contra hearings grind toward their conclusion, the U.S. Congress seems to have the best of it. The Boland Amendment — or the several Boland Amendments — we are told, have been flouted by Administration officials. The clear will of the U.S. Congress has been flagrantly ignored or circumvented by individuals seeking to run their own covert foreign policy.

Congress, the courts, and, ultimately the voting public will decide the merits of the substantive issues behind "Irangate." Certainly foreign policy and intelligence operations are outside the purview of the Tax Foundation.

What is not outside our bailiwick, however, is the notion of public trust, of the ability and willingness of officials of all branches and at all levels of government to keep their promises in as much as these commitments concern fiscal policy. And even as Congress is presently fulminating at the Administration for breaking the law and violating public trust, the Congress's ethical magnifying glass seems to be highly selective.

Quick as it is to condemn the mote in the Administration's eye, Congress is equally slow to see the beam in its own. Specifically, Congress is well into its second decade of ignoring its own strictures for fiscal responsibility. More bluntly, Congress is breaking a number of its own laws. To wit:

■ In 1974, the Budget and Impoundment Control Act committed Congress to a reasonable timetable for preparing and voting expenditures. Congress has never

been in full compliance with that law. Most years, it hasn't even come close.

■ In 1978, the Byrd Amendment stated baldly that, beginning in fiscal year 1981, annual budget outlays of the Federal government "shall not exceed" receipts. Congress simply ignored the Byrd Amendment.

■ In 1982, TEFRA promised \$3 of cuts for every \$1 of tax increase. Recent calculations indicate that we wound up with about 17 cents of cuts for every \$1 of tax hikes.

■ In 1985, the Gramm-Rudman-Hollings deficit reduction act attempted to force Congress and the Administration to do what they had been incapable of doing on their own: move the Budget toward balance through a mandatory series of spending reductions over a five-year period. When the Supreme Court pulled the teeth of enforceability from GRH in early 1986, the process went down the tubes. Compliance last year was a charade. To date, this year, it is nonexistent.

Yet, every year the American taxpayer is subjected to the specious claim that another "real" tax cut has been passed and that new "real" spending cuts have been made. And every year, the budget deficit fails to shrink and, if we're lucky, at best the rate of increase of Federal spending programs slows.

Far be it from us to suggest that Congress abrogate its oversight of foreign policy and intelligence. What we seek is that the 100 U.S. Senators and 435 U.S. Representatives apply to the conduct of their own official responsibilities the same ethical yardstick they are so busily applying to others.

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Watch for details in future issues of Tax Features.

(COLLECTING EACH DOLLAR, from page 2) the more rapid growth in social security taxes and nontax revenues. The other is the slower rise of Federal income taxes as a result of the Economic Recovery Tax Act of 1981 (ERTA). Similar effects due to the Tax Reform Act of 1986 can be expected after 1986. In part, however, the slower growth in Federal income taxes since 1980 has been modified by the rapid increase in state/local taxes. Since 1980 Federal individual income taxes have gone up by 36 percent; in sharp contrast, individual income taxes levied by subnational levels of government have risen by 67 percent. While the Federal government collected 92 percent of all individual income taxes in 1980, its share of the total had dropped to 83 percent in 1985.

Emphasis on Nontax Revenues

Looking at the mix of taxes over the past quarter of a century, Tax Foundation analysts call attention to several major shifts. Revenues from nontax sources have risen from 17.3 cents per revenue dollar in 1960 to 25.1 cents in 1985; tax revenues dropped from 82.7 cents per dollar in 1960 to 74.9 cents in 1985. Nontax revenues in 1975 were over 13 times their size in 1969; tax revenues were about eight times their 1969 levels.

Social security payroll taxes were the fastest growing of all tax sources during the period, rising from 7.0 cents per revenue dollar in 1969 to 16.7 cents in 1975. Social security tax collections in 1985 were over 22 times as large as in 1960.

State and local general sales taxes were the only other tax source showing a rising trend during the 25 years. Their share of the total increased from 3.5 cents per

(SPENDING EACH DOLLAR, from page 2) percentages for social welfare spending actually understate what could be considered the "true" social spending total, according to economists at the Tax Foundation. Broadly defined, social welfare might include public education (shown separately in the table on page 2), as well as subsidized housing and many veterans' services that are included in and not segregable from the totals of other spending categories.

Dominance of Social Welfare Spending

During the 1960s and 1970s, the social welfare programs saw a major increase in

dollar in 1960 to 5.9 cents in 1985. Fiscal year 1985 revenue from general sales taxes exceeded \$84 billion, 16 times their 1960 levels.

Tax sources showing a declining role in the structure were property, selective sales and excises, corporate profits taxes, and miscellaneous taxes.

Numbers on government revenues understate the amount spent by government in 1985 by \$163 billion. The Federal government financed more than one-fifth of its outlays — \$225 billion worth — by borrowing. State and local governments, on the other hand, took in \$62 billion (9 percent) more than they spent, thus reducing the deficit for all governments combined to \$163 billion, or 10 cents per dollar of spending. The fiscal 1985 deficit for all governments was more than six times the amount shown in 1980, and 35 percent larger than the deficit recorded in 1984.

Additional details appear in the accompanying table on page 2.

the proportion of spending being devoted to them, rising from 20.6 cents per dollar of spending in 1960 to 33.6 cents in 1980. By contrast, national defense and international relations spending fell to only 15.6 cents per dollar in 1980 from the 1960 level of 32.3 cents.

Although data for the early 1980s show a modest 2.7 cents-per-dollar increase in the spending share for defense, this outlay category pales by comparison with growth in social spending for the last quarter century. Spending on social programs in 1985 came to 16 times what it had been in 1960, whereas all other programs combined, including defense, increased by just nine times over the same period.

Education Spending Down While Debt Payments Rise

Another notable recent trend has been a relative decline in education spending, which rose to 16.7 cents per dollar of spending in 1970, but by 1985 had fallen back almost to its 1960 level (13.0 cents in 1985 compared to 12.8 cents in 1960).

Interest payments on government debt consumed 10.9 cents per dollar spent in 1985 compared to a smaller 7.9 cent bite in 1980 and 6.2 cents in 1960. Debt-related outlays have been the fastest growing cost to government in recent years.

The four largest spending categories—major social programs, defense and international relations, education and interest—accounted for nearly \$1.2 trillion, or 74.1 cents of every dollar of Federal, state, and local expenditure in 1985.

The table on page 2 provides further details.



TAX FOUNDATION

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TAX·FEATURES

Social Welfare Outlays Dominate Federal Government Expenditures

Welfare Reform: Will It Be Different This Time Around?

Welfare reform has much in common with 17-year cicadas. Both hibernate for long periods of time, suddenly appear and make a lot of noise, and then fade away without accomplishing much. Welfare reform was last considered seriously in the early 1970s when Richard Nixon proposed his Family Assistance Plan. Now, about 17 years later, Congress and the White House are again trying to reform the welfare system.

There is a broad consensus that the existing system is costly, does not give low-income people adequate work incentives, and targets its benefits poorly. There is widespread agreement that parental responsibility should be fostered by work and child support requirements. Reformers see welfare as part of a "contract" between the government and its citizens. The welfare recipients' obligations are to acquire work skills, accept an available job, and share in the financial support of their children. The government's obligations are to enable low-income persons to become self-sufficient by providing financial assistance, supporting services, and job training.

Reformers see welfare as part of a "contract" between the government and its citizens.

Translating this consensus into specific legislation is a difficult task. Many congressional liberals want to use welfare reform to create new entitlements and to increase Federal spending. Conservatives believe that enhancing benefits would discourage people from becoming self-supporting and would perpetuate welfare dependency.

What's Wrong with the Existing Welfare System?

Welfare is a costly system that has not eliminated poverty in the United States. Welfare expenditures now amount to more than \$100 billion a year, yet more than 30 million Americans remain below the government's official poverty line. The argument that

(Continued on page 3)

Governments in the United States paid out more than \$670 billion for social welfare programs in fiscal 1984 (latest officially reported). This represented nearly 53 percent of all Federal, state, and local expenditures, according to economists at the Tax Foundation.

Social welfare outlays in 1984 totaled \$672 billion—enough to give every man, woman and child in the United States \$2,801, according to data recently compiled by the Social Security Administration. This was 5 percent higher than 1983 and more than 4 1/2 times the amount spent as recently as 1970.

The 5 percent advance in spending reported for 1984 was modest by recent standards. During the 1960s social welfare spending rose at an annual rate of nearly 11 percent a year; during the 1970s the rate jumped to almost 13 percent annually. Since 1980 annual growth has averaged just over 8 percent.

Emerging Federal Role

Financing of social welfare programs has gradually shifted more and more toward the Federal government, as compared to state and local units. In 1984, Federal expenditures represented over 62 percent of the total, up from 48 percent in 1960.

Public social welfare programs, as defined by the Social Security Administration, include social security and public employee retirement, Medicare, Medicaid and cash payments under public assistance, unemployment compensation benefits, health, veterans' services, housing, education, and others.

OASDHI Leads the Pack

The largest single social welfare program—Old Age, Survivors, Disability, and Hospital Insurance (OASDHI)—has grown more rapidly than any other social welfare program. Spending for this program now claims more than a third of all social welfare outlays, Tax Foundation economists say.

OASDHI payments in 1984, totaling \$239 billion, were six and one-half times their size in 1970. Under the OASDHI umbrella, social security taxes pay for Federal programs for retirement, survivor benefits, disability, and medical care. (According to the Federal budget for fiscal 1988, OASDHI outlays in fiscal 1988 are estimated at \$298 billion, over 24 percent higher than in 1984, the latest year covered in the SSA tabulations.)

Education a Distant Second

Until the 1970s, the largest category of social welfare programs was public education. In 1976 education was shifted to second place, leaving OASDHI as the dominant social program. At \$152 billion in fiscal 1984, education outlays amounted to 23 percent of all social welfare costs, down from 35 percent in 1970.

(Continued on page 2)

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PAGE 1:
Social Spending Welfare Reform

PAGE 2:
Property Taxes

PAGE 3:
"Front Burner"

INSERT:
Employee Benefits

(SOCIAL SPENDING, from page 1)

Social welfare spending grew much more rapidly than GNP between 1950 and 1976, when social expenditures reached a high of 19.5 percent of GNP, up from 8.2 percent in 1950. Since 1976, this ratio has moved up in some years, down in others, and in 1984 social welfare outlays amounted to 18.2 percent of GNP, down from 19.3 percent in 1983. Since the peak year of 1976, social welfare spending has increased at an annual rate of 9.2 percent a year, as compared to average GNP growth of 10.2 annually. Details in table below.

'85 Property Taxes Broke \$100 Billion Mark

State and local property tax revenues broke the \$100-billion barrier for the first time ever in fiscal year 1985 (latest reported), hitting \$103.8 billion, more than twice the \$51.2 billion they yielded ten years earlier.

Fiscal 1985 collections topped 1984 by \$7.3 billion (7.6 percent), but failed to match property tax gains earlier in the 1980s. In 1985, nonproperty taxes grew by 10.0 percent.

Declining Role at State-Local Level

Property taxes lost their role as the single major tax source for states and localities in 1978, largely in the wake of California's Proposition 13. Before 1978, property taxes had provided more than 35 percent of all state and local government tax revenues. In the first two decades of the 20th century, they provided more than four-fifths of all state-local tax revenues. In 1985, property taxes made up 29.7 percent of these total taxes, the lowest percentage on record.

Much of the decline in the relative importance of property taxes has been filled by rising individual and corporate income taxes. These now make up more than 25 percent of state/local taxes, as compared with less than 20 percent in 1975. Individual income taxes during the decade grew at annual rates exceeding 12 percent; corporate taxes at more than 11 percent a year.

Another view of the declining role of property taxes since 1975 is seen by comparing their annual growth rate for the period (7.3 percent) with the sharply higher rate of increase in nonproperty taxes (10.6 percent). Since 1978, sales and gross receipts taxes have been the leading tax source for subnational governments. These levies provided 36.1 percent annually over the past ten years.

Major Source of Local Revenues

Despite its declining role, the property tax remains the leading tax revenue source for local governments. It provided 74 percent of the total in 1985. Although most states impose some type of property tax, the levies generally apply to a narrow base and furnish under 2 percent of total state tax monies.

(Continued on page 4)

**Social Welfare Expenditures under Public Programs
By Source of Funds and Type
Selected Fiscal Years 1960-1984
(millions)**

Item ^a	1960	1970	1980	1984 ^b
Total expenditures	\$52,293	\$145,856	\$492,796	\$671,972
Social insurance	19,307	54,691	229,754	342,264
OASDHI	11,032	36,835	152,110	239,395
Public employee retirement	2,570	8,659	39,490	58,888
Unemployment insurance	2,830	3,820	18,326	16,104
Workmen's compensation	1,308	2,950	13,457	19,683
Public aid	4,101	16,488	71,799	89,871
Public assistance	4,042	14,434	44,888	61,000
Health and medical programs	4,464	9,907	27,919	37,864
Veterans' programs	5,479	9,078	21,466	26,127
Education	17,626	50,846	121,050	152,025
Elementary and secondary	15,109	38,632	87,150	110,018
Higher	2,191	9,907	26,176	32,643
Vocational and adult	298	2,144	7,375	9,118
Housing	177	701	7,210	10,374
Other social welfare ^c	1,139	4,145	13,598	13,447
From Federal funds, total	24,957	77,337	302,616	419,264
Social insurance	14,307	45,246	191,162	289,884
Public aid	2,117	9,649	48,667	57,666
Health and medical programs	1,737	4,775	12,688	16,496
Veterans' programs	5,367	8,952	21,254	25,882
Education	868	5,876	13,452	12,979
Housing	144	582	6,608	9,068
Other social welfare ^c	417	2,259	8,786	7,289
From state and local funds, total ^a	27,337	68,518	190,180	252,707
Social insurance	4,999	9,446	38,592	52,381
Public aid	1,984	6,839	23,133	32,206
Health and medical programs	2,727	5,132	15,231	21,368
Education	16,758	44,970	107,597	139,046
Other social welfare ^c	723	1,886	4,813	7,706

Percentage Distribution

	100.0	100.0	100.0	100.0
Total social welfare expenditures				
Federal	47.7	53.0	61.5	62.4
State-local	52.3	47.0	38.5	37.6
Exhibit: total as a percent of GNP	10.3	14.7	18.5	18.2

^a Subtotals include items not shown separately. Total financed from state and local funds includes minor amounts for veterans' and housing programs.

^b Preliminary.

^c Includes institutional care, child nutrition and welfare, vocational rehabilitation, and other social welfare programs not elsewhere classified.

Sources: *Facts and Figures on Government Finance* and recent data from Social Security Administration, Office of Research and Statistics.

Tax Features

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

SEPTEMBER 1987

Employee Benefits and Retirement Savings Outlook

Summary

■ Because of the persistent budget problem, Congress will continue to look closely at the tax treatment of employee benefits and retirement income for possible revenue increases.

■ The "tax expenditure" concept facilitates attacks on employee benefits treatment even in areas where there is least application. A recent Congressional Budget Office study, for example, contends private pension plans and IRAs do raise retirement income but not national savings because the tax expenditure effect enlarges the Federal deficit.

■ In the name of cutting back on overlapping retirement income benefits, Congress has imposed significant restrictions on IRAs, just as new evidence appears that IRAs have been making a positive contribution to personal savings.

■ The emergence of a potentially very expensive expansion of Medicare, along with additional progressive taxes to finance it, poses a new threat to retirement income planning.

Despite pervasive changes in the treatment of employee benefits and retirement savings under the Tax Reform Act of 1986, Congress continues to eye this sector for possible new "reforms." The lengthy option list of tax increases prepared by the Joint Committee on Taxation in late June rounds up the usual suspects among employee benefits—repealing or limiting the exclusion of employer-provided health benefits and group term insurance, limiting cafeteria plans, restricting employer-provided meals and lodging, etc. In the pension and retirement savings area, the Joint Committee list goes light. The only significant item in revenue terms appears to be a proposed adjustment of the estate tax deduction for ESOPs.

Other listmakers are not so constrained, however. The

Congressional Budget Office, for example, details the large revenue increments it says could be realized by lowering further the limits on contributions to qualified plans, by repealing 401k plans, or by imposing a 5 percent tax on investment income of qualified plans and IRAs. The 5 percent tax option would be imposed on the plan itself rather than on the beneficiaries and is said to raise \$18 billion over a five-year period. It has received some attention as a practical way to tap the inside buildup of tax-free income in pension trusts and other retirement income plans. The same proposal, of course, could be applied to life insurance policies as well.

The Tax Expenditure Stigma

Short-term revenue considerations, heightened by the fiscal 1988 budget resolution, continue to drive tax policy. But whether or not taxes are increased this year, there is going to be continuing controversy over employee benefits and retirement savings simply because they are deemed to be such a significant part of the "tax expenditure" budget. In fact, the exclusion for contributions and earnings of employer-provided plans is said to be the single largest tax expenditure so categorized—\$287 billion for the fiscal years 1988-1992. This column has taken issue with the concept of tax expenditures, particularly as applied to retirement savings—see Tax Foundation Working Paper, *Tax Treatment of Retirement Savings, December 1985*. But the regular listing of the tax expenditure budget and the large revenue "cost" of specific provisions considered outside of the "normal" tax structure cast official doubt over all such provisions, regardless of their merits. There is also a widespread presumption that retirement savings tax expenditures provide benefits primarily to upper-income groups.

CBO Study

The stigma is clearly evident in a recent Congressional Budget Office study, *Tax Policy for Pensions and Other Retirement Savings*, released in April 1987. This was requested by Senator Robert Dole in 1983 when he was Chairman of the Senate Finance Committee. We suspect he got considerably less than he asked for.

The study first raises some ruckus over the high revenue cost, on a tax expenditure basis, of excluding qualified plans and IRAs from current taxation. It concedes that the tax advantages of these plans do result in significantly

higher income for retirees — an average of 14 percent more income for singles and 21 percent for couples — but claims there is little evidence that the plans raise personal savings rates. The study refers to the old conundrum: does the higher return on tax-deferred savings encourage more of it or just displace other savings with less sacrifice in current consumption? According to CBO the empirical results are "still inconclusive."

CBO finds that pensions and IRAs contribute significantly to participants' wealth and this would represent greater *national* savings, as long as the government is not running a deficit or raising offsetting taxes on capital income. There's the tax expenditure stigma again. It seems that a good part of your pension or IRA contribution is not really your own income but revenue foregone by the Treasury. That, of course, was Senator Russell Long's complaint about the whole tax expenditure concept. At the core of it is the presumption that the government has claim to all the income in the first place, releasing its grasp only on that portion it allows you to keep. Though never so stated, this presumption creeps into official government reports and becomes part of the unspoken language of policy. It equates your pension or IRA contribution with any increase in government spending programs and makes your retirement savings part and parcel of the deficit problem. Income has been defined in a very specific way for filing your income tax return but quite another way for policy that may well affect your future income.

The CBO study then goes on to make some unexceptional observations about the distribution of pension benefits by income and job tenure. Long service workers under defined benefit plans and upper-income groups get the most. This is hardly surprising given overall pension plan participation and the propensity to save for retirement among income classes. Also, of course, the effect of integrating Social Security with private pension benefits does reduce pension benefits to some lower income retirees because they receive proportionally higher income replacement through Social Security.

The inference that CBO draws is that since the lower income retirees and short-term workers receive relatively less in the way of tax advantages, they "pay" for the advantages to others "in the form of higher tax rates, lower government spending or increased Federal debt" than otherwise would occur. Again note the underlying assumption of government's title to the income in the first place.

The CBO report claims that it offers only objective analysis and not recommendations. Yet it lists several legislative options all of which would either restrict further the tax treatment of pensions and IRAs (one is the 5 percent tax on plan investment income) or force a more even distribution of the tax advantages. It is also suggested that any tax increases that would result could be used to expand Social Security or Supplemental Security Income payments to the lower-income elderly.

The biggest problem with such studies is that they do not necessarily ask the right questions. CBO devotes 159 pages to the use—and in its view, abuse—of tax advantages but not one word as to how else we are going to encourage people to provide for their retirement in the uncertain economy of the next century.

They suggest that Social Security could be expanded at the expense of private retirement savings. In other words, government would do the providing. But Social Security has become a distrusted investment particularly among younger workers. There is no question that the gravy days are over and retirees in the 21st century will receive far lower returns in relation to past contributions. The system will have to build up massive and politically-difficult-to-maintain surpluses in the next 20 years to finance the baby-boomers' retirement.

Under the intermediate case (middle-range) assumptions of the Social Security trustees, OASDI benefits as a percentage of taxable payroll will increase from 10.9 percent currently to about 16 percent by the year 2030. According to an analysis by the Institute for Research in the Economics of Taxation, however, when the full cost of Medicare (including both the hospital and medical segments but not any new initiatives) is reflected, that 16 percent of payroll will be reached by approximately the year 2000, zooming to over 26 percent by 2030. What this says about the potential level of payroll taxes (and income taxes, too) is obvious. The message has gotten through that politicians are unlikely to adopt tax rates of such order just to support the old folks. Therefore, don't depend only on Social Security in your retirement planning. The "golden years" could turn out to be pretty lean.

Restricting Choice—Turnabout on IRAs

The approach to encouraging retirement savings that developed in the 1970s and early 1980s was to establish new or liberalized mechanisms to spread tax-deferred benefits around. Hence we had development of expanded HR 10 (Keogh) plans, simplified employee pensions, ESOPs, 401k plans and IRAs. These instruments were designed to reach segments of the population not covered or not adequately covered by qualified pension plans. After 1981, however, a backlash set in. There were concerns about overlapping tax benefits, lack of uniformity and, of course, the alleged large revenue cost of the tax advantages. Congress became less sympathetic to multiple choice benefits and in the Tax Reform Act of 1986 cracked down on the plans with tighter limits, restrictions on early distributions, stiffer anti-discrimination rules, etc. It diminished the latitude of 401k plans and did a complete about-face on IRAs, disallowing the current IRA deduction for upper-middle-and-above income groups who are covered by qualified plans.

This was a significant policy reversal because after 1981 IRAs quickly became the principal means, other than qualified plans, for individuals to avoid some of the income

tax bias against savings. By 1986 IRA assets had accumulated to an estimated \$262 billion with well over 25 million participants. Total 1986 contributions, at about \$45 billion, represented 39 percent of total personal savings last year. While the extent of IRA utilization does rise with income, they are quite popular among middle and upper-middle income groups who comprise the majority of participants.

The new limits will prevent pension plan participants with income over \$40,000 from receiving a full deduction. According to CBO, about 40 percent of those who would have contributed to an IRA in 1988, based on past participation, will no longer be eligible for any deduction and an additional 12 percent would have a reduced deduction. Everyone, of course, can continue to make nondeductible IRA contributions that will still receive the benefit of tax deferral on investment earnings.

An unknown portion of those newly ineligible for full IRA deductions are pension plan participants who have not vested their benefits. The typical defined benefit plan still provides only ten-year cliff vesting. Although this will have to be liberalized in the future under terms of TRA '86, many employees in these times of high labor turnover can work several jobs and never vest their benefits. There was some discussion of this during the Senate consideration of TRA '86. But, in the end, Congress went ahead and denied full deductibility of IRAs for qualified plan participants regardless of vesting status. In this respect, the new restrictions go further than just eliminating the overlapping of tax-deferred benefits.

Contribution to Savings

The contribution of IRAs to overall personal savings has been disputed on the same grounds that CBO mentions with respect to qualified plans. In addition, of course, the \$2,000 limit on individual annual contributions restricts the marginal savings potential. Tax reformers, such as Joseph Pechman of the Brookings Institution, are convinced that IRA accounts represent no more than a swapping of taxable assets for higher after-tax returns with no net gain to national savings.

Other research, however, indicates that IRAs may be making a much more positive contribution. A recent National Bureau of Economic Research study by Steven Venti and David Wise indicates that more than 70 percent of families with IRAs have incomes under \$50,000, and an analysis of the savings patterns of participants showed "almost no substitution of IRAs for other savings." The study's authors believe that the overall personal savings rate has remained low because of reduced pension plan funding, and, if it were not for the IRAs, the overall personal rate would be even lower.

The rapid growth of IRA assets after 1981 would seem to lend support to the Venti-Wise thesis. Certainly, the widespread availability of an institutional discipline for long-term savings must have had some effect, too, in

encouraging retirement planning. Logically, this should help stabilize the capital formation process, even if initial contributions did come out of other savings.

Some growth in IRA assets undoubtedly will continue even with the new restrictions, but individual choice has been narrowed. Venti and Wise estimate that overall IRA contributions will be 13-19 percent less in the years ahead than they would be without the TRA '86 cutback.

Mandating Benefits and Medicare

In the 1980s, it became the conventional wisdom that we were not about to embark on major new spending initiatives in domestic policy, both because of the continuing budget deficit problem and because the citizenry appeared to be voting for a lower profile of the Federal government in this respect. A way was found around the budget dilemma, however, to expand some benefits by simply mandating that employers to pay for them and/or provide them on a more uniform basis. This has been the pattern for certain health benefits for employees or ex-employees and, more broadly, in the pension area under TRA '86. A vast extension of mandated health benefits would occur under Senator Edward M. Kennedy's program, "Minimum Health Benefits for All Workers Act of 1987" (S. 1265).

And now drops another shoe. Congress is actively considering what would be undoubtedly the biggest direct government spending program expansion in domestic policy since the early 1970s. The cost of catastrophic health care legislation pending in both the House and Senate is estimated by the Treasury Department to run \$64-70 billion per year by the year 2005. And this is without any drug benefits contained in the House bill.

To finance the expansion of hospital and other care for the elderly, Congress, for the first time, would turn to a means-tested mandatory tax on income, in addition to hiking the flat rate premium for Part B medical care. Such an approach was dictated by the absence of any spare revenues in the general fund and by an unwillingness to adopt additional, highly unpopular payroll tax increases. Nevertheless, the Treasury estimates that there still could be a revenue shortfall in meeting the added costs of the program of at least \$20 billion annually by the year 2005. Based on past experience with starting new Federal transfer payment programs, this may be a very low estimate.

The means-tested tax, by itself, could be an eye-popper. Under the House measure, for instance, it would start at only \$6,000 of adjusted gross income and rise to a temporary maximum of \$1,160 per elderly couple at \$28,000 of AGI. The supplemental tax, however, would increase every year in line with Medicare costs, presumably on an automatic basis without new legislation. By 1992, it is projected at a maximum of \$1,916 per elderly couple, and by 2005, at \$8,000 in constant 1988 dollars. Under either House or Senate bills, marginal income tax rates for the elderly would jump sharply, countermanding the intent of TRA '86.

It has been pointed out that a majority of the elderly now have private insurance coverage for catastrophic hospital expenses not covered by Medicare. But, instead of concentrating on ways to help those without private insurance, Congress is sweeping on to the grand total government solution that would, in effect, abolish private sector arrangements.

The President is threatening to veto expensive health care legislation, but clearly the forces for program expansion are on the move.

One of the principal arguments for favorable tax treatment of employee benefits, such as for health plans and for retirement income plans in general, is that such arrangements are inherently more flexible and efficient than direct government spending programs. Of course, favorable tax

treatment by itself does not assure full coverage of the population. Therein lies the justification for government imposed minimum standards, anti-discrimination rules, etc. At some point, multiplication of regulations, restrictions, and/or mandating of additional cost burdens on the employer can choke off the market response to benefit and retirement income needs. We may well be seeing this in the case of IRAs.

It is ironic that Congress is contemplating a vast and costly expansion of Medicare to be financed mainly by a progressive tax on retirees—whether or not they have had private insurance coverage and completely unrelated to their consumption of medical services—at a time when tax treatment of retirement income is being cut back, or threatened to be cut back further. This, if anything, is going to require much sharper planning by middle-income workers contemplating their retirement.

Big Deficit Gap Remains

The accompanying table illustrates starkly where the real Federal budget problem lies: spending outstripping tax resources. From a base of a little over \$92 billion and 18 percent of gross national product in 1960, total outlays have exploded eleven-fold to over a trillion dollars in fiscal 1987. Spending grew much faster than the overall economy, peaking at 24.4 percent of GNP in fiscal 1983 before dropping back a bit to 23 percent this year.

In the meantime, overall tax receipts, starting from the same base of just over 18 percent of GNP in 1960 have kept fairly even pace with the economy. There was a dip in receipts as a percent of GNP after the 1981 tax cuts, but by 1987 taxes were back up over 19 percent of GNP, about one-half percentage point higher than the average over the preceding 27 years.

Federal Spending and Receipts
As a Percent of Gross National Product
Fiscal Years 1960-1987



The difference, of course, is the deficit which reached a post-war high of 6.3 percent of GNP in fiscal 1983 and an historic dollar high of \$221 billion in fiscal 1986. Unless stringent fiscal restraint is applied, deficits close to \$200 billion will persist into the 1990s.

It is well to remember how we got into this situation. Certainly on the basis of the post-war record, we are not undertaxed but overspent!

(WELFARE REFORM, from page 1)

poverty has persisted because the government has starved programs for the poor is not supported by the facts. Adjusted for inflation, the government is now spending twice as much on programs targeted to low-income persons as it did when Nixon proposed his Family Assistance Plan.

Evidence that welfare is not effective can be gleaned from the following anomalies:

- It is said that less than \$50 billion could raise all poor persons above the poverty line. This is much less than the amount currently spent to aid the poor. *To do so, however, would require termination of assistance to the "near poor," persons already above the poverty level.*
- About two-thirds of the assistance to the poor is in the form of noncash benefits such as food stamps, medicaid, and subsidized housing. If these benefits were "cashed out," the government could give each poor family \$8,000 a year, much more than it now gives them;
- The Census Bureau has reported that the current data distort the poverty picture. If noncash benefits were included as income, the poverty rate would fall below 10% and 11 million fewer persons would be identified as poor.
- The Advisory Commission on Intergovernmental Relations has found that for each dollar spent, the poverty gap—the difference between the income of the poor and the poverty level—is reduced by less than 50 cents. One reason for this inefficiency is that many welfare recipients are above the poverty line.

The welfare system was established at a time when poverty was concentrated among elderly Americans. That is no longer the case. Almost 40 percent of the poor are children, many of whom live with only one parent. As the face of poverty has changed, the effectiveness of programs aimed at alleviating financial distress has diminished. When welfare serves employment-age adults and their children, it runs the risk of discouraging work.

The "Welfare to Work" Reform

Welfare reform recognizes this changed composition of poverty by emphasizing that public assistance should be an interim measure until recipients are able to support themselves. Under proposals pending in Congress, welfare mothers with children over the age of three could be required to participate in work or training activities. Some bills would also

THE FRONT BURNER

By Robert C. Brown
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"Blame It on Washington"

Even in the heyday of machine-style politics, no big city mayor ever had the temerity to run against his own city: James Michael Curley never went to Brookline to run against Boston. Richard Daley didn't head down to Cicero and run against Cook County.

Only Robert F. Wagner, Jr., came close to such brazen shifting of blame. He campaigned in the primary for his third term as mayor of New York City on a reform ticket.

Washington is different. Here, the connection between reality and rhetoric seems to grow more tenuous by the minute. The latest trend is for politicians of every stripe to wreak havoc on the nation during the legislative year and then run for reelection by blaming what they have wrought on the capital city itself, as if it were some sort of evil abstraction personified—a sort of marble and glass Frankenstein's monster.

The last two Presidents have each successfully campaigned as outsiders, attacking what "Washington" has done. The incumbent ran for reelection by attacking what "Washington" had done during his own first term in office. And he scored the second widest margin ever.

Who did what to whom, of course,

is somewhat problematic, since members of Congress from both parties were also busily running against "Washington."

Because of such shenanigans, there are those who are beginning to think that calling our nation's capital "Disneyland on the Potomac" does a severe disservice to the great cartoonist. At least Walt Disney never pretended to be doing anything other than nurturing our childlike fantasies. Our nationally elected officials, arguably, are in another business: fostering the national well-being and promoting the common good.

The Spanish language has a handy, somewhat elliptical way of avoiding acceptance of responsibility. If you oversleep some morning, you don't tell the boss, "I'm late because I didn't get up on time." You say, "The clock made me late."

Public officials in Washington have put a new spin on such linguistic legerdemain. From foreign policy to tax policy, from budget cuts to honest cost projections of appropriations programs, no one wants to accept responsibility. "Washington"—whatever that means—did it. No individual is to blame. Of course, the problem is: If no one is responsible, then is anyone really in charge?

provide increased child care and transportation assistance to enable low-income persons to get a job. States would be required to enforce child-support laws so that parents would not be able to avoid financial responsibility for their children.

These provisions show that today's welfare reform is far different from earlier versions. It was not long ago that "workfare"—the requirement that able welfare recipients take available jobs—was deemed a dirty word in some quarters. Now it is the centerpiece of efforts to overhaul the outmoded welfare system.

Yet the road to enacting reform is paved with proposals to add billions of dollars to the already massive welfare expenditures. The reform bill sponsored by House Democrats would raise govern-

ment spending by requiring all states to provide benefits to eligible two-parent families and by setting higher Federal reimbursement rates for states that raise benefits. If a state decides to give more money to welfare clients, the Federal government's costs would automatically rise. Moreover, the House bill would allow recipients to remain on welfare by turning down certain low-paying jobs. Whenever they decide that welfare offered a better deal, recipients could continue on it. That does not sound like a powerful work incentive.

The Congressional Budget Office (CBO) has estimated that this bill would add \$5.3 billion to Federal welfare costs over the next five years. This would be the in-

(Continued on page 4)

(WELFARE REFORM, from page 3)
 creased amount of spending, not the full cost of welfare. CBO has cautioned that "these estimates are complex and uncertain," meaning that the added costs might turn out a lot higher. If they do, the Federal government would face additional

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uncontrollable costs because most of the increased benefits would be in the form of entitlements.

Will the results be different this time? There is more bipartisan support for reforming the welfare system than ever before. But past reforms were stymied by efforts to expand welfare benefits. It can happen again.

(PROPERTY TAXES, from page 2)

Slower Growth Per Capita

While total property taxes have risen by nearly 102 percent over the past decade—from \$51.5 billion to \$103.8 billion, the percentage growth in per capita property taxes has been less—80 percent, from \$242 in 1975 to \$435 in 1985.

Moreover, when related to personal income, property taxes have actually declined—from \$45 per \$1,000 of personal income ten years ago to \$34 in 1985, or 24 percent.

Per Capita Trends

On a per capita basis, Wyoming (with collections of \$1,101) and Alaska (\$1,072) far outdistanced any other state. In third position was the District of Columbia (\$727), followed by New Jersey (\$717), and Connecticut (\$703). States with lowest per capita collections were Alabama (\$116), New Mexico (\$150), Arkansas (\$173), Louisiana (\$176), and Kentucky (\$182).

In terms of the decade's percentage rate of growth in per capita property taxes, Alaska, Wyoming, and the District of Columbia headed this list also, followed by Texas and South Carolina. Altogether, 22 states and the District of Columbia

reported a doubling or more in per capita property taxes. The smallest increases were in California, Nevada, Missouri, Massachusetts, and Arizona. No state reported a decline in per capita property taxes between 1975 and 1985.

Per \$1,000 of Personal Income

Property taxes per \$1,000 of state personal income were highest in Wyoming (\$90), Alaska (\$64), Montana (\$60), New Hampshire (\$54) and Oregon (\$53). The lowest property tax burdens by this yardstick were in Alabama (\$12), Delaware and New Mexico (\$15), Louisiana (\$16), and Kentucky and Arkansas (\$18). During the decade only three jurisdictions experienced increases in property taxes in relation to personal income—Alaska (up 100 percent), Wyoming (up 64 percent), and the District of Columbia (54 percent). In five states property taxes for the ten-year period remained unchanged as a share of personal income—Florida, Oregon, Pennsylvania, South Carolina, and Utah. The sharpest reduction in the taxes/income ratio occurred in California (down 52 percent), Massachusetts (down 48 percent), Nevada (45 percent), Missouri (44 percent), and New Mexico (37 percent).

State-by-state rankings of property tax revenue along with trends in property taxes for the 1975–1985 period, both per capita and per \$1,000 of personal income, appear in a table that is available free of charge. For a copy please write or call: Tax Foundation, One Thomas Circle, N.W., Suite 500, Washington, DC 20005 (202) 822-9050.



TAX FOUNDATION

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Property Tax Collections by State, Per Capita and Per \$1,000 Of Personal Income, Fiscal Years 1975 and 1985

State	Per Capita Property Tax				Property Tax Per \$1,000 of Personal Income			
	Amount		Percent	Rank	Amount		Percent	Rank
	1975	1985	Change	1985	1975	1985	Change	1985
Total	\$242	\$ 435	80%	—	\$45	\$34	-24%	—
Alabama	53	116	119	51	13	12	-8	51
Alaska	215	1,072	399	2	32	64	100	2
Arizona	233	367	58	30	47	32	-32	26
Arkansas	90	173	92	49	22	18	-18	46
California	373	420	13	24	63	30	-52	29
Colorado	214	497	132	19	39	37	-5	23
Connecticut	352	703	100	5	55	43	-22	14
Delaware	128	204	59	45	20	15	-25	49
Florida	163	378	132	27	31	31	0	28
Georgia	162	295	82	36	34	26	-24	36
Hawaii	150	293	95	37	25	23	-8	40
Idaho	160	280	75	38	33	28	-15	32
Illinois	281	526	87	16	45	38	-16	19
Indiana	231	378	64	27	44	32	-27	26
Iowa	263	520	98	17	50	42	-16	16
Kansas	253	501	98	18	46	38	-17	19
Kentucky	95	182	92	47	22	18	-18	46
Louisiana	85	176	107	48	20	16	-20	48
Maine	231	471	104	21	51	44	-14	12
Maryland	213	407	91	26	36	28	-22	32
Massachusetts	430	568	32	13	75	39	-48	18
Michigan	292	619	112	9	50	49	-2	7
Minnesota	231	497	115	19	43	38	-12	19
Mississippi	97	210	116	44	26	24	-8	37
Missouri	184	239	30	41	36	20	-44	43
Montana	304	631	108	8	62	60	-3	3
Nebraska	281	541	93	14	53	44	-17	12
Nevada	253	316	25	35	44	24	-45	37
New Hampshire	315	693	120	6	65	54	-17	4
New Jersey	413	717	74	4	66	47	-29	9
New Mexico	95	150	58	50	24	15	-38	49
New York	369	688	86	7	60	48	-20	8
North Carolina	118	247	109	39	26	23	-12	40
North Dakota	192	337	76	34	34	27	-21	35
Ohio	202	374	85	29	37	30	-19	29
Oklahoma	117	226	93	42	26	19	-27	45
Oregon	277	617	123	10	53	53	0	5
Pennsylvania	163	367	125	30	30	30	0	29
Rhode Island	270	588	118	11	50	46	-8	10
South Carolina	101	239	137	40	24	24	0	37
South Dakota	267	455	70	23	57	41	-28	17
Tennessee	117	218	86	43	26	21	-19	42
Texas	191	466	144	22	39	38	-3	19
Utah	152	346	128	33	35	35	0	24
Vermont	299	532	78	15	66	50	-24	6
Virginia	157	366	133	32	30	28	-7	32
Washington	230	411	79	25	41	33	-20	25
West Virginia	101	199	97	46	23	20	-13	43
Wisconsin	271	569	110	12	52	46	-12	10
Wyoming	283	1101	289	1	55	90	64	1
District of Columbia	197	727	269	3	28	43	54	14

Source: Department of Commerce, Bureau of the Census; and Tax Foundation computations.